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LIMITED COMPANIES AND THEIR ACCOUNTS

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CHAPTER ONE

FORMS OF BUSINESS ORGANIZATION

To gain a proper understanding relative to the accounts of Limited Companies (corporations) it is necessary, or at least desirable, to compare this form of business organization with others, so that the differences may be made apparent, because it is those differences which call for special features in the accounting.

In the main there are three distinct forms of business organization. The simplest of these is the Sole Proprietorship, where one person establishes a business and carries it on alone. The second is the Partnership, where two or more have combined together to carry on business, and the third is the Corporation, which includes Limited Companies.

Sole Proprietorship and Partnership

A brief review of the first two forms of business organization, before giving an explanation of the third, will draw attention to their position from the point of view of risk and stability.

In the Sole Proprietorship the owner receives all the profit; has to bear any losses; and is personally responsible for the debts of the business.

While the accounts for the business will be kept separate entirely from the personal accounts of the proprietor outside of the business, any property used in the business belongs to the proprietor, and the title to any real estate is in his name. Should the assets of the business be insufficient to meet the claims of creditors, any further property owned by the proprietor may be drawn upon to meet the claims. The profits are his; the risk is his; and the size of the business is limited by the amount of capital that he can personally supply and the credit he can command.

A Partnership differs from the Sole Proprietorship in that there are two or more proprietors who divide the profits, and the losses, either equally or on any other agreed basis, and who are personally liable to creditors should the assets of the business be insufficient to meet the claims.

PARTNERSHIP NOT A PERSON. If real estate is included in the partnership property the title is not in the name of the partnership, as such, for it is not a person. It may be in the name either of one or more of the partners, in trust for all the partners trading under a certain firm name, or in the names of all the partners constituting the firm. Each partner is an agent of the firm and can bind his co-partners in any matter relating to the business.

Here, again, the profits belong to the proprietors, who must also bear the risk, their property outside of the firm being liable for the firm's debts, and the extension of the business is limited by the amount of capital that the partners can supply and the amount of credit they can personally command.

If action were to be taken against a partnership in the courts, it would not be against the firm in its own name, but against the partners trading under that name (again because the firm is not an entity in itself).

ACCOUNTS FOR PROPRIETORS' INVESTMENTS. In the accounts of both a sole proprietorship and a partnership firm there are individual accounts for the capital investment of each proprietor. This emphasizes the personal character of the partners' interests. This is further emphasized by the fact that the death of a partner dissolves the firm. He is an integral part of it. Under certain conditions, also, the incapacity of a partner would be sufficient reason for a court to dissolve the firm.

PARTNERSHIP REQUIRES NO AUTHORITY. The partners operate under an agreement among themselves, and in that agreement the rights and privileges of each should be set forth. The rights and privileges are not conferred on them by a higher power, except in so far as the law of partnership protects their interests and establishes, in law, their obligations to each other and to the public. A partnership is formed by the will of the partners. They decide that they wish to become partners and do not require authority to do so. There is no power to tell them that they may or may not, but they must register a certificate of partnership in order that the public may have access to information as to who the partners are.

PARTNERSHIP DEFINED. A partnership is defined in law as "the relation which subsists between persons carrying on a business in common, with a view to profit." In defining a partnership the several Provincial Acts follow the general definition, with a provision to make it clear that the relation between members of a company that is a chartered body is not a partnership within the meaning of the Act.

Corporation

Corporation Defined. There are many definitions of a Corporation, one of which is: A corporation is an artificial person, being created by law,

and composed of individuals with the capacity of perpetual succession and of acting within the scope of its character as a natural person.

Legal Position of a Corporation. A corporation can sue in the courts and can be sued. It should be added that a corporation as an artificial person is an entity, and has an identity separate entirely from the members who compose it. It may own property in its own name and this is not the property of its members. It may owe debts, but they are the debts of the corporation and not of its members. It has perpetual succession, which means that it is not affected by any change in membership. Members may transfer their interests or, if they die, their interests will be transmitted as part of their estate. The place of those who cease to be members is taken by others, and so the corporation may go on indefinitely through the lives of many generations of members.

A Limited Company, also referred to as a Joint Stock Company, is one form of corporation.

Methods of Forming Corporations. A corporation, in Canada, must obtain a charter from the Dominion or from a Provincial Government, which charter outlines its powers, rights, and privileges.

There are three methods in particular by which these rights and privileges may be given. These may be outlined briefly as follows—

First, they may be given by a Special Act of the Parliament or Legislature.

Second, they may be given by Letters Patent, under the provisions of the Companies Act of the Dominion or of one of the Provinces. The majority of industrial and commercial companies obtain their charter in this way.

Letters Patent consist of an open letter addressed by the Sovereign "To all to whom these presents shall come." In this case it recites the fact that a corporation has been given existence with certain powers, rights, and privileges. These powers, rights, and privileges are further set out and controlled in the terms of the Act under which the Letters Patent are issued. The Letters Patent are under the Great Seal of the issuing office.

Third, a method, as adopted in some of the Provinces, is to register a Memorandum of Association, and information required, with the Registrar of Joint Stock Companies who, if existence is given to the corporation, issues a certificate.

Considering these cases in their order, it may be said that the evidence of the charter of the company's rights, etc., is set out by a Special Act, or by Letters Patent, or by Registration and the issue of a certificate thereof.

Letters Patent *v.* Charter. It is rather difficult to distinguish between Letters Patent and Charter, but that there is a difference is obvious from the fact that the Companies Acts, under which charters are issued, state, in the case of the Dominion, that "The Secretary of State may, by Letters Patent, under his seal of office, grant a charter," etc. Similar language is used in the Provincial Act, except that it is the Lieutenant-Governor who may, by Letters Patent, grant a charter, etc.

It will be obvious that, under the second method, while the charter is set out in the Letters Patent, the meaning of the terms "Letters Patent" and "Charter" is not the same. Any open communication from the Sovereign under the Great Seal, granting rights of any kind, would be Letters Patent, hence the term "Letters Patent" refers to the communication, and the communication conveys the evidence of the "Charter."

Summarized, it may be said that the Letters Patent constitute the form in which the evidence of the charter is given, while the substance of the communication setting forth the name, powers, rights, etc., constitutes the charter itself.

In New Brunswick, Quebec, Ontario, Manitoba, and also in the case of Dominion incorporation, evidence of the charter is given in the formal and impressive way of issuing Letters Patent which, since they convey evidence of the charter, are sometimes referred to as the Charter of Incorporation. In the other provinces, companies are formed by registration, the agreement being filed in the office of the Registrar of Joint Stock Companies, and a certificate issued by him.

The charter will state, among other things, the authorized share capital of the corporation and outline its powers. For example, the charter may state that the capital of the company shall be $1,000,000.00, divided into 10,000 shares of $100.00 each. The face or nominal value of the share (in this case $100.00) is the *Par Value.* Capital is obtained by the issue of these shares to the public, and, as legal procedure is provided for the increase of capital stock if necessary, there is no definite limit to the possible expansion that may be brought about.

The Term "Limited" is applied to indicate that the liability of a shareholder is limited to the amount he has promised to contribute to the capital funds of the company. Thus, if he subscribed for ten shares of $100.00 each, at par, and has paid $600.00 on account of them, and the company fails, his liability is limited to the $400.00 that he has promised to pay but has not yet paid.

Under some jurisdictions, companies may also be limited as to guarantee, or specially limited, but the same idea holds in any case.

The name of each limited company must indicate that it is incorporated

and that the liability of the shareholders is limited. This explains the use of the word "Limited" in the names of such corporations.

Joint Stock Companies. In Canada, Limited Companies are usually referred to as Joint Stock Companies. However, this term does not necessarily mean an incorporated company everywhere.

In Quebec, under the Partnership Law, provision is made for joint stock companies, a feature of which is that shares in the firm are transferable, and the control and management are exercised through a board of directors chosen by the members. In the matter of liability in the event of bankruptcy, if the assets are insufficient to meet the claims, the members are personally liable to the full extent of their private property, just as in any other joint partnership.

The same idea is found in the United States and is referred to and discussed by authorities in that country.

It is possible, then, that while a corporation in the form of a Limited Company is a Joint Stock Company, a Joint Company need not be a corporation.

In Canada, as pointed out, the term Joint Stock Company, unless otherwise qualified, will be taken to imply an incorporated company with limited liability of its members. When the term Joint Stock Company is used in this discussion a Corporation is intended.

The term Joint Stock indicates that the members hold shares representing their proportionate interest in the enterprise and that these are held in common, that is, that each member has full rights relative to the shares that he holds, and so may transfer them to others without affecting the position of other shareholders.

Capital of the Corporation. Since the Limited Company is a corporation, and is thus an entity separate from the members who compose it, there will be no capital accounts, in the general books of the company, for the individual members. The capital set up in the accounts is the capital of the corporation and not of the members, although it is contributed by the members. This explains one of the main differences between the accounts of the company and those of a partnership firm. The shareholders or members have an equity in the corporation, but it is the corporation that owns the assets and owes the liabilities.

AUTHORIZED CAPITAL. The amount of capital stated in the charter is the amount that the company is given authority to issue in shares in order to obtain capital funds. This is referred to as the "Authorized" Capital.

SUBSCRIBED CAPITAL. Assuming that it is made known to the public that the company is ready to receive applications for shares; that a number of persons apply for shares at the price stated—which, except in the

case of mining companies, must in most jurisdictions be at least the par value; and that applications have been accepted, so that there is then a binding contract between the corporation and the applicants (who now may be termed Subscribers), the amount so subscribed foı is referred to as the "Subscribed" Capital.

Paid-up Capital. As consideration is received from time to time for the shares so issued, the total of this consideration makes up the "Paid-up" Capital.

Summary. From the above it is evident that the Authorized Capital does not represent capital until it has been issued, but indicates merely the limit to the authority given to the company to issue shares of its capital stock with a view to obtaining capital funds. The Subscribed Capital represents the amount of authorized capital that has been issued, and the amount which subscribers have promised to contribute as capital funds. These contributions, when received, constitute the Paid-up Capital.

Record Books. It is obvious that in recording the Capital Stock of a company, where one account is used to indicate either the promise or the contribution of the members, there must be some record that will show the relation of the members each to the other, and show how the total amount of capital stock, as shown in the financial books, is made up by contributions of the members. The record books will be illustrated later, after the financial books are opened and the need for the books of record is apparent.

Double Entry Essential. It should be borne in mind that, properly to comply with the law of the Dominion and Provinces, the double entry principle must be applied to the accounts of a company. The law requires a Balance Sheet, which can be taken only from books kept on the double entry principle. If the books were kept on the single entry principle, the statement of assets and liabilities would not be a Balance Sheet, but a Statement of Affairs. Limited Companies are required, also, to keep a record of Income and Expenditure.

CHAPTER TWO

ENTRIES TO OPEN THE BOOKS OF ACCOUNT

ASSUMING that the reader has a fair knowledge of the principles of Double Entry Bookkeeping, he should have no difficulty in understanding the special entries to be made in the Books of Account of a Limited Company, as distinguished from those of an unincorporated concern. The opening entries to be made in the books of a newly organized company will be first explained; then those resulting from the purchase of a going concern by a company; and, subsequently, those relating to the amalgamation of several companies.

The Capital Stock Account

In the General Ledger of a Limited Company the account which corresponds to the Capital Account of an unincorporated concern is called Capital Stock, and may be kept in such a way as to represent the Paid-up Capital, the Subscribed Capital, or the Authorized Capital of the company. For the purpose of comparison, the opening entries for a company will be made in each of these ways.

Entries to Record Paid-up Capital.

Problem. A company is incorporated with an authorized capital of $150,000.00, divided into 1,500 shares of $100.00 each. Applications are received and allotments are made as follows: A. Andrew, 200 shares; B. Brookes, 250 shares; C. Crabbe, 110 shares; D. Dinmont, 180 shares; E. Early, 170 shares; the other shares remaining unallotted. A first call of 30 per cent. is made upon allotment, the balance being left subject to the call of the directors. Payment is received in due course in full of the call. Make the required entries in the Books of Account in such a way that the Ledger Account for Capital Stock will show Paid-up Capital.

Solution. Assume first that an Allotment List[1] has been prepared, and that the first three columns, showing the number of shares allotted, the par value of the shares, and the amount of the first call thereon, have been filled out properly; no entries have yet been made in the Cash Received column. Looking over the Allotment List of the above problem it will be seen that the total Subscribed Capital is $91,000.00, on which a first call of 30 per cent., amounting to $27,300.00, has been made. Then make the

[1] The books of record are explained and illustrated in Chapter Three.

following journal entry, to be posted subsequently to the General Ledger, charging the shareholders with the amount of the first call.

Shareholders	$27,300.00	
To Paid-up Capital		$27,300.00
Call No. 1, 30 per cent, as per allotment list or, as per following list (and enumerate them in the Journal). Reference may be made also to the minutes of the directors providing for the call.		

It will be better to carry Shareholders' account in the General Ledger as a controlling account, with individual accounts in the Share Ledger, than to open a separate account for each shareholder in the General Ledger.

Subscribers' Account. In dealing with the accounts of the shareholders in the General Ledger, it is customary, when there are a number of shareholders, to treat them collectively under the ledger title, "Shareholders," "Subscribers," or some similar name. When this is done, it is a great convenience to enter the names of the individual shareholders (each on a separate line) with the amounts of their respective calls on the debit side of "Shareholders'" account in the Ledger, and, when the calls are paid, to credit this account by entering the amounts received against the names of those who pay them, in the same manner as is usual with Petty Personal accounts. If preferred, separate General Ledger accounts may be kept for the charge to each shareholder, in which case the following journal entry would be made—

A. Andrew	$6,000.00	
B. Brookes	7,500.00	
C. Crabbe	3,300.00	
D. Dinmont	5,400.00	
E. Early	5,100.00	
To Paid-up Capital		$27,300.00
Call No. 1, 30 per cent. upon the Subscribed Capital.		

Cash Record. The cash received in payment of calls should be kept separate from that received in the ordinary course of business, either by entering it in a special column or on a special page, or even in a separate Cash Book, if there are many shareholders. Each shareholder is credited in this special Cash Book with the amount of his payment, and the total receipts from this source are ultimately carried to the General Cash Book to the credit of "Shareholders," whence they are posted to the General Ledger. This is the same in effect as making a journal entry—

Cash	$27,300.00	
To Shareholders		$27,300.00

Significance of Account Balances. When posted, Shareholders' account will balance if the calls have all been paid. Any difference between

the two sides of this account will show Calls in arrears. Concurrently, the amount paid in by each shareholder should be posted from the special Cash Book to the column provided in the Instalment List[1] for this purpose. An inspection of this list should at any time show the individual amounts remaining unpaid.

If individual accounts are kept in the General Ledger, then the entry for the receipt of the cash would be made in the same way as for moneys received in payment of any ordinary account; that is each person would be credited through the Cash Book for the cash paid in settlement of the first call.

Expressed in journal form, this Cash Book entry would be—

Cash	$27,300.00	
To A. Andrew		$6,000.00
" B. Brookes		7,500.00
" C. Crabbe		3,300.00
" D. Drummond		5,400.00
" E. Early		5,100.00

Provided similar entries are made for each call, the Capital Stock account will always show the Paid-up Capital, subject to any unpaid calls.

From the Instalment Book, accounts in the Share Ledger would afterwards be opened, and entries made as previously described. The Special Share Cash Book, the General Cash Book, and the General Ledger are shown below, as they should appear after the foregoing entries have been made.

SPECIAL SHARE CASH BOOK

Dr.		Cash				
				Ins. List No.		
19— Jan.	2	A. Andrew 1st call of 30% on 200 shares		1	6,000.00	
"	3	B. Brookes 1st call of 30% on 250 shares		1	7,500.00	
"	4	C. Crabbe 1st call of 30% on 110 shares		1	3,300.00	
"	4	D. Drummond 1st call of 30% on 180 shares		1	5,400.00	
"	4	E. Early 1st call of 30% on 170 shares		1	5,100.00	
		Total carried to General Cash Book	C.B.	3		27,300.00

[1] The books of record are explained and illustrated in Chapter Three.

GENERAL CASH BOOK

Dr. *Cash*

19— Jan.	5	Shareholders' Receipts from Call No. 1 as per Share Cash Book, Fol. 2	G.L. 1		27,300	00

GENERAL LEDGER

Paid-up Capital

						19— Jan.	3	By Call No. 1 J.	2	27,300	00

Shareholders

19— Jan.	3	Call No. 1 J.	2	27,300	00	19— Jan.	5	By Cash C.B.	3	27,300	00

Instead of being entered as above, Shareholders' Account might have been posted in the following form—

Shareholders

19— Jan.	3	A. Andrew	J.	1	6,000	00	19— Jan.	3	Cash	C.	2	6,000	00
,,	3	B. Brookes	J.	1	7,500	00	,,	3	Cash	C.	2	7,500	00
,,	3	C. Crabbe	J.	1	3,300	00	,,	4	Cash	C.	2	3,300	00
,,	3	D. Dinmont	J.	1	5,400	00	,,	4	Cash	C.	2	5,400	00
,,	3	E. Early	J.	1	5,100	00	,,	4	Cash	C.	2	5,100	00
					27,300	00						27,300	00

Each Call, and the payment thereof, would be handled in the manner above described, the result being that Capital Stock would always show Paid-up Capital, subject to any arrears shown by the balance of Shareholders' Account.

Unpaid Calls in Balance Sheet. Should a Balance Sheet be prepared when some calls are unpaid, the amount called up will be entered in an inner column in the Balance Sheet, and from this will be deducted unpaid calls, and the net Paid-up Capital extended in the outer column.

The account for Paid-up Capital represents the amount called up, and, if there are arrears in payment of calls, these offset the Paid-up Capital balance, so that it is only by bringing the two together in the Balance Sheet that the actual Paid-up Capital is shown.

Unpaid Calls Not Accounts Receivable. The amount of unpaid calls should not be included in Accounts Receivable. The term Accounts Receivable refers to amounts owing by trade customers for value received. When these customers pay their accounts there is no increase in the assets, but merely a change.

A Subscriber is a *contributory*, that is, he is one who has promised to contribute to the assets of the company. He has not received value. The asset would be recorded only when it is received.

Entries to Record Subscribed Capital.

Problem. Show the required entries for the previous problem, provided Capital Stock Account is kept in such a way as to represent the Subscribed Capital instead of the Paid-up Capital.

Solution. By this method of dealing with the Capital Stock Account, the aggregate amount of the subscription (that is, the amount subscribed) and the amount subscribed but not called may be readily shown. Under some of the Company Acts it is required that the Subscribed Capital and the amount paid thereon shall be shown in the Balance Sheet. This method readily supplies the information.

The entries to be made are substantially the same as those already explained. The Allotment Book, or the Stock Book and Applications, shows the total subscription of $91,000.00 on which a first call of 30 per cent., amounting to $27,300.00, has been made, leaving $63,700.00 uncalled. A special account will be opened for this uncalled stock, which must not be confused with the stock for which subscriptions have not yet been received. This would be done by making a special entry, as follows, for the amount of stock subscribed—

Subscription	$91,000.00	
To Subscribed Capital		$91,000.00
Total Subscription as per Stock Book and Applications.		

This would be followed by a second entry for the amount of the first call—

Shareholders	$27,300.00	
To Subscription		$27,300.00
Call No. 1, 30 per cent. on Subscribed Stock.		

The Subscription Account indicates the amount of contributions promised by the subscribers and the term stands for those subscribers, although it is in an abstract form to avoid making a direct charge to the subscribers before the calls are made. As calls are made, a direct charge is set up, as illustrated, and the debit in Subscription Account reduced.

The Subscription Account shows the amount for which the subscribers may be ultimately liable, while the account for Subscribers shows the amount for which they are immediately liable.

Direct Liability Only When Call is Made. There is no direct liability to pay for shares until a Call is made and notice thereof given to the shareholder, and, until that time, the Statute of Limitations does not operate against the company. Thus, if shares were partly called up and paid and no further calls made for a period of twenty years and then a call is made, the actual liability of the subscriber, for that call, starts at that time, and from the date that call is due the Statute of Limitations will run.

Significance of Balances in "Subscription" and in "Subscribers'" Accounts. When these entries are both posted, the difference between the two sides of Subscription Account will show the amount of stock subscribed but not yet called, the Shareholders' Account will show the amount called but unpaid, and the Subscribed Capital Account will show the total amount subscribed. The entries for the cash received in payment of calls are exactly the same as those already explained in the solution to the preceding problem. Each subsequent call would require an entry charging Shareholders and crediting Subscription for the aggregate amount of the call. As soon as the cash received in payment of calls has been posted to the proper accounts, Shareholders' Account would balance. If there is any difference, it represents money due on calls but not yet paid in, or, in other words, calls in arrears. In this case the General Ledger would appear as follows—

Subscribed Capital

					19— Jan.	3	By Subscription J.	2	91,000	00

Subscription

19— Jan.	3	To Cap. Stock J.	2	91,000	00	19— Jan.	3	By Call No. 1 J.	2	27,300	00

Shareholders

19— Jan.	3	To Call No. 1	J.	2	27,300	00	19— Jan.	3	By Cash	C.	2	27,300	00

Not Desirable to Charge Subscribers Before Calls Made. Another method in common use, which might be given as an alternative for the above, is to debit Shareholders' Account for the total subscriptions and credit it for the payment made, thus allowing the Uncalled Stock to stand as a debit balance in Shareholders' Account instead of opening a separate account for it. This plan, however, is objectionable on the ground that the shareholders, as pointed out above, although liable at the call of the directors, are not liable until the call has actually been made, and therefore should not be made to appear on the books of the company as owing a debt which they do not yet owe, and which they may never be asked to assume.

Instalments. If, on the other hand, the subscriptions have been made on the understanding that payment in full would be required immediately after allotment, or in instalments on dates already determined, Subscription Account may be eliminated. In the former case, Shareholders' Account would at once be debited with the full amount subscribed, and Subscribed Capital credited. As the cash was received in settlement, Shareholders' Account would be credited from the Cash Book. Provided the dates were fixed on December 5, one month before the first payment, notice being then given, and payments were to be made in three instalments—30 per cent. on allotment, 50 per cent. in three months, and the balance in six months—the following journal entry would be made—

Instalment No. 1, 30 per cent., due Jan. 5, 19—	$27,300.00	
Instalment No. 2, 50 per cent., due Apr. 5, 19—	45,500.00	
Instalment No. 3, 20 per cent., due July 5, 19—	18,200.00	
To Subscribed Capital		$91,000.00
For Subscribed Capital as per Stock Book and Minute Book, page —.		

Each Instalment Account is handled in the same way as Shareholders' Account, as explained in connection with this and the previous problem. The names of the individual shareholders may be placed under each Instalment Account on the principle of the Petty Personal Account, charging them with their respective instalments and crediting them as payments are made. Cash receipts on account of shares would be entered either in a special Share Cash Book, or directly into the General Cash Book, whence postings would be made to the Instalment Accounts. Assuming only the first instalment of the above to have been paid, the General Ledger would appear as follows—

Subscribed Capital

							19—					
							Jan.	5	By Subscriptions	J.	1	91,000.00

Instalment No. 1. Due Jan. 5, 19—

19—							19—					
Dec.	5	A. Andrew	J.	1	6,000.00		Jan.	3	By Cash	C.	2	6,000.00
,,	5	B. Brookes	J.	1	7,500.00		,,	3	,, Cash	C.	2	7,500.00
,,	5	C. Crabbe	J.	1	3,300.00		,,	4	,, Cash	C.	2	3,300.00
,,	5	D. Dinmont	J.	1	5,400.00		,,	4	,, Cash	C.	2	5,400.00
,,	5	E. Early	J.	1	5,100.00		,,	4	,, Cash	C.	2	5,100.00
					27,300.00							27,300.00

Instalment No. 2. Due April 5, 19—

19—					
Dec.	5	A. Andrew	J.	1	10,000.00
,,	5	B. Brookes	J.	1	12,500.00
,,	5	C. Crabbe	J.	1	5,500.00
,,	5	D. Dinmont	J.	1	9,000.00
,,	5	E. Early	J.	1	8,500.00

Instalment No. 3. Due July 5, 19—

19—					
Dec.	5	A. Andrew	J.	1	4,000.00
,,	5	B. Brookes	J.	1	5,000.00
,,	5	C. Crabbe	J.	1	2,200.00
,,	5	D. Dinmont	J.	1	3,600.00
,,	5	E. Early	J.	1	3,400.00

In connection with the above, it might be well to impress upon the reader that, in the event of there being a large number of shareholders, the Application and Allotment Book would be ruled to show the details of the different instalments, and only totals would be posted from the Journal to the different Instalment Accounts.

If a balance sheet is prepared before any further calls are made, Capital Stock will appear in the Balance Sheet thus—

Subscribed Capital	$91,000.00	
Deduct—Uncalled Capital	63,700.00	
Paid-up Capital		$27,300.00

In this way, when finally extended, the Paid-up Capital is shown as the amount of actual capital. All items in connection with Capital Stock

should be grouped and the Paid-up Capital extended as the equity of the shareholders.

ARRIVING AT PAID-UP CAPITAL. In the above, Subscribed Capital indicates the amount promised for capital stock issued that is to be treated as capital. This is offset by any debit balance in Subscription Account, indicating amounts uncalled, as illustrated, and, if there are arrears in the calls made, it is further offset by this amount, so that these arrears in the form of unpaid calls would also be deducted before the Paid-up Capital is extended. The actual capital contribution is the amount paid up. The Company Acts (in most cases) require that the Paid-up Capital shall be shown, whether they require the Subscribed or not, and the difference between an amount owing by a subscriber on his calls and the amount owing by a customer for goods should be observed.

When goods are sold to a customer on account he has received value, and his promise to pay is set up as an asset in the place of the goods that were sold to him. A subscriber has not received value in any tangible form, but has promised to contribute to the capital of the company. His contributions will appear as assets when they are made, but not before. There is the further consideration that it is only by deducting the unpaid calls from the amount called up that the actual Paid-up Capital is shown. Each account relating to Capital and to Subscribers records one part of the information relative to Capital Stock, and it is only when all the information supplied by these accounts is brought together that the whole or net result is evident.

Entries to Record Authorized Capital.

Problem. Make the entries for the transactions in the last two questions in such a way that Capital Stock Account will show the Authorized Capital.

Solution. This necessitates the opening of a special account to record the Unsubscribed Stock, which may also be called Unissued Stock. Journalize as follows—

1.	Unsubscribed Stock	$59,000.00	
	Subscription	91,000.00	
	To Authorized Capital		$150,000.00
	To show Total Authorized Capital, of which $91,000.00 has been subscribed per Allotment Book.		
2.	Shareholders	$27,300.00	
	To Subscription		$27,300.00
	For Call No. 1, 30 per cent., per Minute Book, page —.		
3.	(In Cash Book)		
	Cash	$27,300.00	
	To Shareholders		$27,300.00
	For cash received in payment of Call No. 1.		

When the posting has been completed, the General Ledger will show Unsubscribed Stock debited for $59,000.00, which is the amount remaining unsubscribed. Subscription Account will show a debit balance of $63,700.00, which is the amount of Subscribed Stock not yet called in. Shareholders' Account will balance as before, if the calls have been fully paid. Authorized Capital will stand credited for $150,000.00, which is the entire Authorized Capital of the Company. It is evident that, in the future, instead of crediting Authorized Capital Stock, it will be necessary to credit Unsubscribed Stock, the debit balance of which always shows the amount of Unsubscribed Stock which the Company has at its disposal.

If a balance sheet is prepared, in this case, it will be necessary to deduct from the Capital Stock Authorized the amount Unsubscribed; from that balance, the amount Uncalled; and, from this last balance, the amount of Calls Unpaid, to be able to extend the Capital Stock Paid-up. These accounts affecting capital are all proprietorship accounts, and the proprietorship, under the head of Capital Stock, can be shown only by crediting these in a way that will bring out the net amount.

Call Accounts

In the foregoing explanations, Shareholders' Account has been charged with the total amount due when a Call was made. Instead of doing this, a special account for each Call may be opened on exactly the same principle as explained in the case of Instalment Accounts. When the first Call was made, Call No. 1 would be debited with the amount thereof, and Capital Stock Paid-up credited, if only Paid-up Capital is being shown in the books, or Subscription Account, if either Subscribed Capital or Authorized Capital are set up in the books. Cash received in payment of this Call would be credited through the Cash Book to Call No. 1. The difference between the two sides of Call No. 1 Account shows the balance remaining unpaid on this Call. Similarly, when the second Call was made, Call No. 2 Account would be opened and handled in the same way. The names of the individual shareholders may, if desired, be entered under the Call Accounts in the same manner as illustrated in connection with the Instalment Accounts.

Payments with Applications, and Applications in Excess of Intended Allotment

When it is made known that a certain amount of the Capital Stock of a Limited Company is made available for subscription, it is not to be expected that the applications received will be for the exact number of shares to be issued.

If those making application are required to remit a stated amount with their applications, funds will be received in advance of allotment and, if

all applications are not accepted, the funds received will, in part, be applied to shares for which applications are accepted, and the remainder of the application money will be returned to those whose applications are not accepted.

Applicants v. Subscribers. Those who send in applications to purchase shares are not at that time subscribers or shareholders but Applicants. The application constitutes the offer to purchase and the allotment, with notice to that effect, constitutes the acceptance, and it is only when allotment has been made, and notice given, that there is a binding contract.

Record of Application. As applications are received they are recorded in the Application and Allotment Book, together with the amount of the deposit received, and, when shares are allotted, the information is recorded in the space for that purpose. There is thus a basis for the opening of Share Ledger Accounts.

The Amounts Received with Applications are held in trust, preferably in a Trust Bank Account, pending allotment, and must be recorded as such. It will be appropriate to credit an account for "Applicants" pending final disposition. When the application offer has been accepted by notice of allotment, the amount may then be applied on account of the shares issued to subscribers.

The problem that follows is taken to illustrate the accounting procedure.

Problem. The H Company, Ltd., was formed with an authorized capital of $800,000.00 in shares of $100.00 each.

Applications were invited for 6,000 shares at par. The terms of issue were $10.00 a share with application, and $20.00 a share on allotment. $30.00 a share was called up one month after allotment, and $40.00 a share three months after allotment.

Applications were received for 6,150 shares and $10.00 a share with application was received. The Board allotted 6,000 shares only.

All paid on allotment, but only 5,800 have to date paid the first call and 5,700 have paid the last call. Make the necessary entries and prepare the resultant balance sheet.

It may be assumed that applications were received on January 1, 19— and allotment made on January 15.

Solution—

NOTE. In the solution, effect is given to the distinction between applicants and subscribers. A distinction is also made between the instalments payable on application and allotment and the amounts called up later. The amounts payable with application and allotment are not calls, but are

instalments payable under the terms of the issue, and the parties, up to that time, are not subscribers. From time to time after allotment, calls are made at the discretion of the directors. In order that the events may be followed in their order, all entries for the purpose of illustration are made in journal form.

19—			
Jan. 1	Cash To Applicants Receipt of above amount with applications for 6,150 shares. See Application Book, page —.	$61,500.00	$61,500.00
,, 15	Subscription To Capital Stock—Subscribed Allotment of 6,000 shares at par.	600,000.00	600,000.00
,, 15	Subscribers—Due on Application To Subscription $10.00 a share due on application.	60,000.00	60,000.00
,, 15	Applicants To Subscribers—Due on Application To transfer from applicants to subscribers, amount received with applications for 6,000 shares.	60,000.00	60,000.00
,, 15	Applicants To Cash Return of application money for shares not allotted.	1,500.00	1,500.00
,, 15	Subscribers—Due on Allotment To Subscription $20.00 a share due on allotment.	120,000.00	120,000.00
,, 15	Cash To Subscribers—Allotment Payment of $20.00 a share.	120,000.00	120,000.00
Feb. 15	Subscribers—Call 1 To Subscription Call of $30.00 a share.	180,000.00	180,000.00
Feb. 15	Cash To Subscribers—Call 1 Amount to date, on Call 1.	174,000.00	174,000.00
Apr. 15	Subscribers—Call 2 To Subscription Last Call, $40.00 a share.	240,000.00	240,000.00
,, 15	Cash To Subscribers—Call 2 Amount to date on Call 2.	228,000.00	228,000.00

LEDGER

Dr. *Capital Stock Subscribed* Cr.

				19—			
				Jan. 15	Subscription	J. 1	600,000.00

Dr. *Subscription* Cr.

19—				19—			
Jan. 15	Capital Stock	J. 1	600,000.00	Jan. 15	Application	J. 1	60,000.00
				,, 15	Allotment	J. 1	120,000.00
				Feb. 15	Call 1	J. 1	180,000.00
				Apr. 15	Call 2	J. 1	240,000.00

Dr. *Applicants* Cr.

19—				19—			
Jan. 15	Subscribers	J. 1	60,000.00	Jan. 1	Cash	J. 1	61,500.00
,, 15	Cash		1,500.00				

Dr. *Subscribers—On Application* Cr.

19—				19—			
Jan. 15	Subscription	J. 1	60,000.00	Jan. 15	Applicants	J. 1	60,000.00

Dr. *Subscribers—On Allotment* Cr.

19—				19—			
Jan. 15	Subscription	J. 1	120,000.00	Jan. 15	Cash	J. 1	120,000.00

Dr. *Subscribers—Call 1* Cr.

19—				19—			
Feb. 15	Subscription	J. 1	180,000.00	Feb. 15	Cash	J. 1	174,000.00

Dr. *Subscribers—Call 2* Cr.

19—				19—			
Apr. 15	Subscription	J. 1	240,000.00	Apr. 15	Cash	J. 1	228,000.00

Dr.		*Cash*				*Cr.*
19—			19—			
Jan. 1	Applicants	61,500.00	Jan. 15	Applicants	J. 1	1,500.00
,, 15	Allotment	120,000.00				
Feb. 15	Call 1	174,000.00				
Apr. 15	Call 2	228,000.00				

THE H COMPANY, LTD.

Balance Sheet
April 15, 19—

Assets

Cash			$582,000.00
			$582,000.00

Shareholders' Equity

Capital Stock—			
Subscribed		$600,000.00	
Deduct Unpaid Calls—			
Call 1	$6,000.00		
Call 2	12,000.00	18,000.00	
Paid-up Capital			$582,000.00
			$582,000.00

The term "Subscribers" could be omitted entirely in connection with the amounts payable on application and on allotment, but it has been brought into the solution merely to connect the parties who become Subscribers with the subscription, and avoid any confusion. Instead of an extra account, the cash received with applications could be credited to Applications, and after allotment is made the entries may be—

Subscription	$600,000.00	
To Capital Stock Subscribed		$600,000.00
Applications	60,000.00	
To Subscription		60,000.00
Applications	1,500.00	
To Cash		1,500.00
Allotment	120,000.00	
To Subscription		120,000.00

This avoids the use of separate accounts for Applicants and Amounts due on Application, although the latter method probably gives more detail.

Alternative Solution (in part). If only Paid-up Capital is to be recorded, the solution will be simplified. For the purpose of illustration the entries may be set out as below—

19—				
Jan.	1	Cash	$61,500.00	
		To Applications		$61,500.00
,,	15	Cash	120,000.00	
		To Allotment		120,000.00
,,	15	Applications	60,000.00	
		Allotment	120,000.00	
		To Capital Stock (Paid-up)		180,000.00
Feb.	15	Subscribers—Call 1	180,000.00	
		To Capital Stock		180,000.00
,,	15	Cash	174,000.00	
		To Subscribers—Call 1		174,000.00
Apr.	15	Subscribers—Call 2	240,000.00	
		To Capital Stock		240,000.00
,,	15	Cash	228,000.00	
		To Subscribers—Call 2		228,000.00

When these entries are posted to the Ledger, the Balance Sheet will be similar to that already set up, except that Subscribed Capital is not stated, although in this case the amount subscribed and the amount called up are the same.

THE H. COMPANY, LTD.

Balance Sheet
April 15, 19—

Assets

Cash			$582,000.00
			$582,000.00

Shareholders' Equity

Capital Stock—			
Subscribed and Called up		$600,000.00	
Deduct Unpaid Calls—			
Call 1	$6,000.00		
Call 2	12,000.00	18,000.00	
Paid-up Capital			$582,000.00
			$582,000.00

Issuing Shares at a Premium

Shares are not infrequently issued at a Premium instead of at Par. Particularly is this the case in the incorporation of a bank, or other financial institution, which may be desirous of putting the concern on a sound foundation at once, by providing funds from the premium to cover costs of organization and possibly the creation of a large Reserve from the premiums thus obtained; or when a well-established commercial company with a large amount of accumulated profits makes a further issue of shares.

When subscriptions are payable in instalments, the first moneys received are apportioned to Share Premium Account, so that the subscriber would not receive any credit in the Share Ledger for stock payments until after the Premium had been fully paid. For instance, if the $100.00 shares of a certain concern are issued at 50 per cent. premium, and made payable in two instalments of $75.00 each, entries should be made as follows—

1. Shareholders	$75.00	
To Share Premium		$50.00
,, Paid-up Capital Stock		25.00
For first instalment on shares allotted at 50 per cent. premium as per Directors' Minute Book, page —.		
2. Cash (in Cash Book)	75.00	
To Shareholders		75.00
Payment of first instalment on shares.		

Then, on the date for the payment of the second instalment, make entries as follows—

1. Shareholders	$75.00	
To Paid-up Capital Stock		$75.00
For second instalment on shares allotted at 50 per cent. premium.		
2. Cash (in Cash Book)	75.00	
To Shareholders		75.00
Payment of second instalment on shares.		

If preferred, instead of handling as above, an account for each instalment may be opened immediately after allotment.

If Subscribed Capital were to be recorded, and the par value of the shares issued was $400,000.00, the entries would be—

Subscription	$600,000.00	
To Premium on Shares		$200,000.00
,, Capital Stock Subscribed		400,000.00
and		
Subscribers	300,000.00	
To Subscription		300,000.00
and		
Cash (in Cash Book)	300,000.00	
To Subscribers		300,000.00

This sets up the subscription and the first instalment. The entries for the second instalment would be similar to the last two entries above.

Premium on Shares is Neither Revenue nor Profit, but a Capital Receipt, and so should be shown in a separate account for Premium on Shares, and not transferred to Profits nor confused with them. The legal or stated capital is represented by the par value, so that this is the limit to the amount credited in the Capital Stock Account. The premium is a further capital contribution but separate from the legal capital, and is in the nature of a capital surplus.

It should be noted that there is a premium only because a par value has been placed on the shares and they have been issued at a higher amount. If they had been true No Par Value shares there could be no premium, but the whole amount could be placed to the credit of capital.

As the premium represents a capital surplus, it may be applied to write off capital expenses, such as Preliminary or Organization Expenses, or Commission on Shares, or it may be applied to write off capital losses.

There is nothing in law, apparently, that would prevent the appropriation of premiums on shares for dividend purposes, if there is a balance remaining after writing off capital expenses or losses, but it is not generally considered good policy to do so, since they do not represent earnings.

Preliminary Expense Accounts

When a new company is organized there are usually a great many expenses of a kind not likely to occur again, such as law fees, cost of charter, printing prospectus, account books, etc. In large concerns, such as fire and life insurance companies, and quite frequently in mercantile or manufacturing companies, these expenses are usually so great as to make it absolutely unfair to charge them against the business of the first year. This is overcome by opening a special account called either Preliminary Expense Account or Organization Expense Account, against which all items of this nature are charged.

This is not an operating expense, but a capital expense. As there is some value attached to the organization, the outlay may be termed a capital expense asset. As, however, the asset would not have any realizable value to speak of, and the items are looked upon more in the nature of expense, it is usually desired to have the amount written off over a period of perhaps two to five years, according to the amount of the accounts and the nature of the business. Since this is not an operating expense, the portion written off each year should not be charged to the current Profit and Loss Account. For instance, if the directors of a company consider it advisable to spread Preliminary Expense, $2,000.00, over a period of four

years, a journal entry would be made at the end of each of the four years as follows—

Profit and Loss Appropriation	$500.00	
To Preliminary Expense Account		$500.00
To write off one-fourth of the preliminary expense account.		

This would appear in the Profit and Loss Appropriation Account as an item of $500.00 in each of the four years. At the end of the first year the Balance Sheet would show Preliminary Expense Account as an asset of $1,500.00; at the end of the second year $1,000.00; at the end of the third $500.00; and at the end of the fourth it would have entirely disappeared.

Writing Off Organization Expense. If there should be premium on shares, which is a capital surplus, this capital expense may be written off by a transfer from the Premium Account. Thus, a capital surplus is used to write off a capital expense. If there is no premium on shares, or other capital surplus, the amount will be written off by a charge against the net profits, i.e. a portion of the net profits will be appropriated to write down the expense. The balance remaining is carried as an intangible asset. It is frequently found in a balance sheet under Deferred Charges. While the charge is deferred, it is not deferred against operations, and will not be a charge against revenue. It is better then to show it in the balance sheet after the total of the tangible fixed assets has been extended and in a group with such items as Goodwill and Patents, and not as a deferred charge against operations.

Commission on Shares is another item that is in the nature of an organization expense, but, because of special legal requirements governing these commissions, the amount should be charged to a special account. It will, however, be written off in a manner similar to that taken for Organization Expense.

Problem. The A Co., Ltd., with an authorized capital of $500,000.00 in shares of $100.00 each, issues $200,000.00 of this at 105, the first call being for $25.00 a share, which is paid. Organization Expense, $2,000.00, and Commission on Shares, $5,000.00, were paid for in cash.

Record the above, showing Subscribed Capital in the accounts, and prepare the Balance Sheet.

Solution. (Entries all in journal form.)

Subscription	$210,000.00	
To Premium on Shares		$10,000.00
,, Capital Stock subscribed		200,000.00
To record issue of $200,000.00 in shares at 105.		

Subscribers—Call No. 1	$50,000.00	
To Subscription		$50,000.00
Call of $25.00 a share on 2,000 shares.		
Cash	50,000.00	
To Subscribers		50,000.00
Organization Expense	2,000.00	
To Cash		2,000.00
Commission on Shares	5,000.00	
To Cash		5,000.00
To record outlay for costs of organization and commission on shares issued.		

As there is a Capital Surplus from the Premium on Shares, $10,000.00, and Capital Expenses of $2,000.00 + $5,000.00, or $7,000.00, the premium may be applied to write off these.

Premium on shares	$7,000.00	
To Organization Expense		$2,000.00
,, Commission on Shares		5,000.00

THE A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Cash		$43,000.00
		$43,000.00

Shareholders' Equity

Capital Stock—		
Subscribed	$200,000.00	
Deduct Amount Uncalled	160,000.00	
Paid-up Capital		$40,000.00
Premium on Shares		3,000.00
		$43,000.00

CHAPTER THREE

COMPANY BOOKS AND STATEMENTS

Company Bookkeeping. The books and accounts relating to a Joint Stock Company are to some extent regulated by the Act under which it has been incorporated. The Dominion Act and the various Provincial Acts are substantially the same in this respect. A quotation from one of the Acts is given for the purpose of indicating in particular what is generally required, but the reader should refer to the Act of the Dominion and of his own Province to obtain the exact provisions that he may require.

Briefly stated, the actual bookkeeping of a Joint Stock Company differs from that of a partnership as follows—

(*a*) In the entries relating to the Capital of the Company.
(*b*) In the entries relating to the Distribution of Profits.
(*c*) Special Records regarding Shareholders, Directors, etc., as are called for by the various Company Acts.

Law Governing Books of Record. The Ontario Companies Act, referring to the Books of Record, or Statistical Books, provides as follows—

"The Corporation shall cause the secretary, or some other officer specially charged with that duty, to keep a book or books wherein shall be kept recorded—

(*a*) A copy of the Letters Patent and of any Supplementary Letters Patent issued to the corporation, and, if incorporated by Special Act, a copy of such Act, and the by-laws of the corporation duly authenticated.
(*b*) The names, alphabetically arranged, of all persons who are or who have been shareholders or members of the corporation.
(*c*) The post office address and calling of every such person while such shareholder or member.
(*d*) The names, post office addresses, and callings of all persons who are or have been directors of the corporation, with the date at which each person became or ceased to be such a director.

And in the case of a corporation having share capital—

(*e*) The number of shares held by each shareholder.
(*f*) The amounts paid in, and remaining unpaid respectively, on the shares of each shareholder.
(*g*) The date and other particulars of all transfers of shares in their order."

It is provided further that these books of record shall, during reasonable business hours of every day, except holidays, be kept open for the

inspection of shareholders, members, and creditors of the corporation and their personal representatives or agents, at the head office or chief place of carrying on its undertaking, and every such shareholder, member, creditor, agent or representative may make extracts therefrom.

A penalty is provided against any director or officer who refuses to permit any person entitled to do so to inspect the books.

COMPANIES INFORMATION. Under the Companies Information Act, provision is made for an annual return by every Joint Stock Company doing business in the Province of Ontario of a summary in duplicate of its affairs on printed schedules provided by the Government. These forms call for detailed information respecting the shares and shareholders of the company, its directors, etc., as on the 31st day of December, and must be made out on or before the 1st day of February of the following year. One copy must be posted up in a conspicuous position in the head office of the company on or before the 2nd day of February, and the other must be sent by registered letter to the Provincial Secretary on or before the 8th day of February. Companies not complying with the provisions of this section incur a penalty of $20.00 for every day default continues.

Books of Record kept by Joint Stock Companies

To meet the requirements of the various Acts, in a way that will best suit the needs of the business, the following books are usually kept by Joint Stock Companies, in addition to those used by other commercial concerns—

1. The Memorandum of Agreement and Stock Book.
2. The Application and Allotment Book.
3. The Instalment Book.
4. The Instalment Receipt Book.
5. The Stock Certificate Book.
6. The Transfer Book.
7. The Register of Transfers.
8. The Share Ledger.
9. The Dividend Book.
10. The Register of Directors.
11. The Minute Book.

The above are not necessarily all separate books. Some of them are almost invariably bound together. Explanations and illustrations regarding the use of each will be found in the pages which follow.

Memorandum of Agreement and Stock Book. This book, known in some Provinces as "Memorandum of Agreement," in others "Memorandum of Association," etc., the statutory form of which for Ontario is here shown, contains the subscriptions of the incorporators of the Company. It must be made out in duplicate and must contain all special conditions regarding

Preference Stock, or otherwise intended to have a bearing on the stock of the Company. Both copies of the book must be forwarded to the office of the Provincial Secretary, along with the Petition and necessary affidavits in making application for Letters Patent. One copy is kept there on file and the other is returned to the Company. The form is given with subscriptions entered.

Application and Allotment Book. It is the practice to send out blank application forms to persons who are likely to invest in the shares of the newly organized company. The purpose of the Application and Allotment Book is to keep a systematic record of the applications received and the shares subsequently allotted thereon. The application forms are numbered consecutively as received, and entered upon separate sheets corresponding to the initial letters of the surnames of the applicants. If the list is comparatively small, one sheet may prove sufficient. The first part of each sheet consists of special columns for the names, occupations, and addresses of the applicants, together with the number of shares applied for and the deposits received on account of same. This information is placed before the directors, as soon as the subscription list closes, for the purpose of allotting the shares. Letters of Allotment are sent to those whose applications have been accepted in part or in full, and Letters of Regret are mailed at the same time to those whose subscriptions have been refused.

In the illustration it has been assumed that the Toronto Yeast Company, Ltd., has placed upon the market for open subscription 405 shares of its stock, par value $100.00 each, a deposit of 10 per cent. to be made with the application and the balance to be paid on allotment. The Application and Allotment Book shows the directors that 455 shares have been subscribed for, which is fifty more than they intend to issue. After carefully considering the applications, they decide to reject the applications of Bailey and Cook and allot the others in full. Letters of Allotment should be sent immediately to the latter, informing them of the number of shares allotted and the balance still due upon them. The other two should receive Letters of Regret, containing cheques for the amount received with their applications. At the same time, that portion of the Application and Allotment Book dealing specially with allotments would be completed.

The Share Ledger is usually written up from this book immediately after the date fixed for the payment of the balances due upon allotment.

Instalment Book. This book is for the purpose of entering up a list of the shareholders and showing the amount payable by each when calls are made upon the stock. Sometimes, instead of using a separate book, the Application and Allotment Book is ruled with additional columns for each Call. As stock does not usually change hands until fully paid up, the Instalment Book may be prepared with special columns for the different calls, thus doing away with the necessity of writing the names more than once. Interest should be charged on all instalments not paid on or before their due date. This, however, is frequently neglected. In the accompanying illustration a column has been provided for this purpose.

Instalment Receipt Book. The receipts issued to shareholders when they pay their Calls are known as Instalment Receipts, or Scrip. The blanks are bound together and consecutively numbered like bank cheques. The shareholder signs an acknowledgment, on the stub of the receipts, that he has received Scrip for the amount stated thereon. These Receipts are exchanged for Stock Certificates as soon as the shares have been fully paid up.

Stock Certificate Book. This book is very similar in form to the Instalment Receipt Book and consists of blank stock certificates with the corresponding stubs. As soon as all the calls on the stock have been paid in, Stock Certificates are issued in exchange for the Instalment Scrip held by the shareholders. Whenever shares are transferred, the transferring shareholder returns his certificate to the company and a new certificate is issued to the purchaser for the shares transferred. If the seller still retains any shares, he receives a new certificate also. The certificate returned should be stamped "Cancelled" and pasted to the proper stub in the Certificate Book.

Transfer Book. When shareholders are desirous of transferring any or all of their shares to another person, a regular form of transfer must be signed by the transferor for this purpose. These forms are bound together in a book kept at the company's office, and generally include not only the transfer but an agreement to be signed by the transferee, in which he formally accepts the stock. These transfers and acceptances should be kept in the company's possession, as they are generally the only written evidence it has of the transaction.

Some companies have to enter up so many transfers that they are obliged to employ a person for the special purpose of keeping the Transfer Book. This person is known as the Transfer Clerk. Shares are frequently transferred by brokers, holding a power of attorney from the transferor. In such cases the power of attorney should be filed carefully away, or attached to the actual transfer. Forms for this purpose are commonly printed on the back of the Stock Certificates, as follows—

For value received..............................hereby assign and transfer unto.........................
..............................share...................of the capital stock represented by the within certificate, and do hereby constitute and appoint..............................my attorney, to transfer the said stock on the books of the within-named company, with full power of substitution in the premises.

....

Date..................................19........

Signed in the presence of

....

In passing, it may be well to call attention to the fact that shares not fully paid up can be transferred only with the consent of the directors of the company. Indeed, this consent is required by many companies, even after the stock has been fully paid up, to prevent the shares getting into the hands of undesirable persons. Under the Dominion Act, shares on which calls made are not paid cannot be transferred.

Register of Transfers. Referring back to clause (*f*) of the section quoted from the Ontario Companies Act, it will be seen that Joint Stock Companies are required to keep a record of the date and other particulars of all transfers of stock in their order. Such a record should be kept in a careful and systematic manner, otherwise the accounts of the individual shareholders are not likely to be reliable. Several forms are in use for this purpose, but the one illustrated here will be found suitable to the needs of most companies. An extra column may be added to record the serial numbers of the shares transferred, if desired. The information recorded in this Register is, of course, obtained from the Transfer Book. The necessary entries in the Share Ledger may be posted either from the register or the original transfers.

The Share Ledger. The purpose of this book, which is frequently called the Stock Ledger, is to show at a glance full information regarding the stock held by individual shareholders. An account is kept with each of them, showing his name, occupation, address, the number of shares he acquires, transfers, or holds, the par value of the said shares, and the amounts paid in or remaining unpaid thereon. The various entries are usually obtained from the Application and Allotment Book, the Instalment Receipt Stubs and the Transfer Register, although many prefer posting all cash items from the Cash Book.

Several forms of stock ledgers are submitted herewith, all of which have been found to be thoroughly practical.

In Share Ledger "A," Sinclair has been allotted 120 shares of stock on January 8, 19—, and has paid a first call of 40 per cent. thereon on January 15. (Refer to form.) As all of the entries under the headings "Shares" and "Par Value of Shares" are self-explanatory, no remarks need be made about these. The other columns, however, may not be so easily understood. As 40 per cent., or $40.00 per share, is the amount paid on the first call, this multiplied by the number of shares gives us $4,800.00 as the "Paid-up Stock acquired." This amount deducted from the Par Value of the stock held gives the balance remaining unpaid. On April 14, 19—, Sinclair transfers 40 shares and, as $40.00 has been paid on each of these shares, he is really transferring $1,600.00 Paid-up Stock. This deducted from the $4,800.00 he held before the transfer leaves him $3,200.00 Paid-up Stock. Subtract the $3,200.00 from $8,000.00 Par Value and the difference, $4,800.00, is the amount remaining unpaid on the 80 shares now held by Sinclair. Call No. 2, amounting to 40 per cent., or $40.00 per share, is paid by Sinclair on the 80 shares held by him on June 8, 19—. This gives

$3,200.00 which has to be added to the Paid-up Stock previously held by him and deducted from the previous unpaid balance. On August 10, 19—, he buys 30 shares of the same stock from another shareholder and, as $80.00 per share has already been paid on it, he thus increases his Paid-up Stock by $2,400.00, making a total of 110 shares of stock on which $8,800.00 has been paid and $2,200.00 remains unpaid. The remaining transactions are dealt with in a similar manner.

Many accountants prefer the arrangement of the columns in Share Ledger "B" to that shown in "A." The information given is exactly the same in both cases, so that a detailed explanation of the entries given in the illustration is entirely unnecessary. Where it is desired, the columns dealing with the par value of the shares may be omitted. This, however, is not recommended.

Share Ledger "C" is an excellent form. It may be arranged with the Share Account beneath the Cash Account, or alongside of it. The Share Account contains a record of the shares only; the Cash Account of the amounts due on Call and paid thereon. The same transactions have been entered as in Share Ledgers "A" and "B" in order that the different forms may be compared more readily. On January 8th, when the allotment was made, the number of shares allotted was entered in the Share Account. At the same time, the Cash Account is charged up with the amount of Call No. 1 and credited with the cash when paid. On April 14th, 40 shares are transferred and entered accordingly in the Share Account, no entry being made in the Cash Account, as the latter is not affected in any way. On June 8th, Call No. 2 is made and, as Sinclair holds 80 shares on this date, he is charged with $40.00 per share on this number, and credited when the cash is paid. The transfer of 30 shares from Watt on August 10th increases Sinclair's shares to 110, on which he is charged $20.00 per share for the third and last call on September 16th. Payment being made on this date, his Cash Account balances. When it does not balance it indicates the amount unpaid on Calls that have been made.

Dividend Book. This book is simply a list of the shareholders with their addresses, against which are written the number of shares held by each and the dividend payable thereon. In some cases, an extra column is ruled in which the shareholder signs an acknowledgment of the receipt of his dividend. This, however, is seldom done, as dividends are nearly always paid by cheques drawn in such a way that the endorsements thereon answer this purpose.

Register of Directors. The use of this book will be readily understood by studying the illustration given herewith. As the Board of Directors seldom consists of more than five members of the company, it is better to write out a new list each year, rather than attempt to use the same list with corrections.

A specimen Register, written up for two successive years, is illustrated.

Form of Memorandum of Agreement and Stock Book

We, the Undersigned, do hereby severally Covenant and Agree each with the other to become incorporated as a Company under the provisions of the Ontario Companies Act, under the name of the Toronto Yeast Company, Limited, or such other name as the Lieutenant-Governor in Council may give to the Company, with a capital of One Hundred Thousand Dollars, divided into One Thousand Shares of One Hundred Dollars each.

And We Do Hereby severally, and not one for the other Subscribe for and Agree to take the respective amounts of the capital stock of the said Company set opposite our respective names as hereunder and hereafter written and to become shareholders in such Company to the said amounts. In Witness Whereof, we have signed.

Name of Subscribers	Seal	Amount of Subscription	Date and Place of Subscription		Residence of Subscriber	Name of Witness
			Date	Place		
Alexander Holmes	O	$9000	Feb. 6, 19—	Toronto	58 Shaw St., Toronto	W. T. King
James Wilson	O	8000	,, 7, ,,	Toronto	132 Jarvis St., Toronto	W. T. King
Walter Scott	O	6000	,, 7, ,,	Toronto	84 Carlton St., Toronto	W. T. King
Thomas Murray	O	6000	,, 7, ,,	Toronto	96 College St., Toronto	W. T. King
Donald Hamilton	O	5000	,, 8, ,,	Toronto	98 St. George St., Toronto	W. T. King

Application and Allotment Book

No. of Application	Date of Application		Name of Applicant	Ocupation	Address	No. of Shares Applied For	Deposit Paid on Application	Cash Book Folio	No. of Shares Allotted	Subscription Price per Share	Total Value of Shares Allotted	Balance Due on Allotment	Date of Cash Receipt or Payment		Cash Received in Payment of Allotment Money	Cash Book Folio	Cash Returned to Applicants Declined	Share Ledger Folio	No. of Share Certificate
5	Mar.	8, 19–	Allan, Samuel	Merchant	84 Church St., Toronto	200	$2000	6	200	$100	$20000	$18000	Mar.	14, 19–	$18000	16		1	1
4	,,	8, ,,	Aikens, Thos.	Manager	92 Yonge St., Toronto	50	500	6	50	100	5000	4500	,,	14, ,,	4500	16		2	2
3	,,	6, ,,	Bailey, Wm.	Accountant	64 Scott St., Toronto	40	400	4					,,	12, ,,		14	400		
2	,,	4, ,,	Brown, James	Lawyer	86 Bay St., Toronto	75	750	2	75	100	7500	6750	,,	14, ,,	6750	6		3	3
6	,,	9, ,,	Cook, David	Grocer	312 Spadina Ave., Toronto	10	100	8					,,	12, ,,		14	100		
7	,,	10, ,,	Cross, Alex.	Grocer	1 Bathurst St., Toronto	10	100	10	10	100	1000	900	,,	15, ,,	900	18		4	4
1	,,	3, ,,	Darwin, Chas.	Traveller	68 Dunn Ave., Toronto	20	200	2	20	100	2000	1800	,,	16, ,,	1800	18		5	5
8	,,	11, ,,	Dick, John	Manufactu'r	82 St. George St., Toronto	50	500	10	50	100	5000	4500	,,	16, ,,	4500	18		6	6
						455	$4550		405		$40500	$36450			$36450		500		

Instalment Book

Call No. 2—40%—*Payable May* 15, 19—

Shareholders	Address	No. of Shares	Amount of Call	Interest on Overdue		Cash Received		Date	Received		C.B. Fol.	S.L. Fol.
Abbott, John	Barrie, Ont.	50	$2000			$2,000	00	19—	May	13	60	1
Bond, William	Meaford, Ont.	40	1,600			1,600	00	,,	,,	14	62	2
Doe, John	Galt, Ont.	40	1,600	8	00	1,608	00	,,	June	15	64	3
Fenn, Alex.	Kitchener, Ont.	25	1,000	10	00	1,010	00	,,	July	14	62	4
Gunn, George	Kitchener, Ont.	30	1,200			1,200	00	,,	May	15	64	5
Jack, David	Stratford, Ont.	50	2,000			2,000	00	,,	,,	15	64	6
Line, Joseph	Stratford, Ont.	40	1,600			1,600	00	,,	,,	14	62	7
Roe, Richard	Preston, Ont.	10	400			400	00	,,	,,	13	60	8
		285	$11,400	$18	00	$11,418	00					

Form of Instalment Receipt

THE TORONTO YEAST CO.

LIMITED

INSTALMENT RECEIPT.

No. 12.

Samuel Allan, Barrie, Ont.

Second Call of 40 Per Cent.

On 50 shares of $100 each.

Amount, $2,000. S.L. Fol. 1.

Dated May 13, 19—

Received Receipt for above Instalment.

SAMUEL ALLAN.

No. 12 INSTALMENT RECEIPT. 50 Shares, $2,000

THE TORONTO YEAST COMPANY, Limited

RECEIVED from Samuel Allan, the sum of Two Thousand Dollars, being the Second Call of Forty per cent. on Fifty Shares of the Capital Stock of **THE TORONTO YEAST COMPANY, LIMITED,** said shares having been reserved and set apart for him, or his assigns, on condition that he, or they, fulfil the terms of the subscription.

IN WITNESS WHEREOF we hereunto subscribe our names and affix the Corporate Seal of the Company this 13th day of May, 19—.

CHAS. DARWIN, Secretary.

Seal of Company

JAMES BROWN, President.

Form of Stock Certificate

Certificate No. 5.

For 30 Shares

Issued to

DAVID COOK

Kitchener, Ont.

Dated July 3, 19—

From whom transferred

....

Dated.. 19—

Received Certificate No. 5 for 30 Shares this 6th day of July, 19—.

DAVID COOK.

Number 5 | Authorized Capital Stock, $100,000. | Number of Shares 1,000 of $100 each | Shares 30

This Certifies that

DAVID COOK

is the owner of Thirty fully-paid Shares of One Hundred Dollars each of the Capital Stock of

The Toronto Woodenware Co., Limited

The said Shares are transferable only on the Books of the Company in person or by Attorney on surrender of this Certificate.

Seal

In Witness Whereof *the said Company has caused this Certificate to be signed by the duly authorized officers under the Corporate Seal of the Company this 3rd day of July, 19—.*

CHAS. DARWIN,
Secretary.

JAMES BROWN,
President.

Form of Transfer Book

Share Led. Folios	
18	FOR VALUE RECEIVED, I, James Clark, do hereby assign and transfer to William Scott, all my right, title, and interest in Ten Shares of the Capital Stock of *The Toronto Woodenware Company, Limited*, on which has been paid the sum of One Thousand Dollars, and which are now standing in my name on the books of the said Company. WITNESS my hand at the office of the Company, in the City of Toronto, this 15th day of October, 19—. Witness: D. HAMILTON. JAMES CLARK.
22	I HEREBY ACCEPT the foregoing Transfer of Ten Shares of the Capital Stock of *The Toronto Woodenware Company, Limited.* Dated this 15th day of October, 19—. Witness: D. HAMILTON. WILLIAM SCOTT.

Form of Transfer Register

No. of Transfer	Date of Transfer			Transferor's Name	Transferor's Address	S. L. Folio	Shares Transferred: How Many	Shares Transferred: Par Value	Shares Transferred: Paid In	Shares Transferred: Unpaid	Transferee's Name	Transferee's Occupation	Transferee's Address	S. L. Folio
1	19-	Apr.	3	Jas Wood	Guelph	3	10	1000 00	1000 00		Jas. Walters	Lawyer	Toronto	12
2	19-	May	10	A.T. Long	Ottawa	6	15	1500 00	1500 00		Thos Green	Merchant	Ottawa	14
3	19-	Sept.	12	F.S. Small	Goderich	8	10	1000 00	800 00	200 00	S. Morton	Accountant	Stratford	16
4	19-	Oct	13	W. Hunter	London	9	7	700 00	700 00		A. Arnold	Merchant	Toronto	18

Share Ledger "A"

William Sinclair,
Guelph Ont. Grocer.

DATE			PARTICULARS	FOL. OR NO.	SHARES TRANSFERRED	SHARES ACQUIRED	SHARES BAL. HELD	PAR VALUE TRANSFERRED	PAR VALUE ACQUIRED	PAR VALUE BAL. HELD	PAID UP CALLS TRANSFERRED	PAID UP CALLS ACQUIRED	PAID UP CALLS BAL. HELD	UNPAID STOCK
19-	Jan	8	Allotment	1		120	120		12000 –	12000 –				12000 –
19-	"	15	Call No 1, 40%	6			120			12000 –		4800 –	4800 –	7200 –
19-	Apr.	14	Trans. to S Gray	3	40		80	4000 –		8000 –	1600 –		3200 –	4800 –
19-	June	8	Call No 2 40%	38			80			8000 –		3200 –	6400 –	1600 –
19-	Aug.	10	Trans from L Watt	16		30	110		3000 –	11000 –		2400 –	8800 –	2200 –
19-	Sept.	16	Call No 3, 20%	84			110			11000 –		2200 –	11000 –	
19-	Nov	7	Trans to C Dodds	34	60		50	6000 –		5000 –	6000 –		5000 –	

Share Ledger "B"

William Sinclair.
Guelph. Ont.

Grocer

DATE			PARTICULARS	FOL. OR NO.	TRANSFERRED			ACQUIRED			BALANCES			UNPAID STOCK
					SHARES	PAR VALUE	PAID UP	SHARES	PAR VALUE	PAID UP	SHARES	PAR VALUE	PAID UP	
19-	Jan.	8	Allotment	1				120	12000 -		120	12000 -		12000 -
19-	"	15	Call No. 1, 40%	6						4800 -	120	12000 -	4800 -	7200 -
19-	Apr.	14	Trans. to S. Gray	3	40	4000 -	1600 -				80	8000 -	3200 -	4800 -
19-	June	8	Call No. 2, 40%	38						3200 -	80	8000 -	6400 -	1600 -
19-	Aug.	10	Trans. from L. Watt	16				30	3000 -	2400 -	110	11000 -	8800 -	2200 -
19-	Sept.	16	Call No. 3, 20%	84						2200 -	110	11000 -	11000 -	
19-	Nov	7	Trans. to C. Dodds	34	60	6000 -	6000 -				50	5000 -	5000 -	

Share Ledger "C"

William Sinclair.
Guelph. Ont. Grocer.

SHARE ACCOUNT—$100.00 EACH

SHARES DISPOSED OF					SHARES ACQUIRED					BALANCES HELD		
DATE		FOLIO	PARTICULARS	NO. OF SHARES	DATE		FOLIO	PARTICULARS	NO. OF SHARES	DATE		NO. OF SHARES
19– Apr.	14	3	Transfer to S. Gray	40	19– Jan.	8	1	Allotment	120	Jan.	8	120
Nov	7	34	" " C. Dodds	60	Aug	10	16	Transfer from L. Watt	30	Apr.	14	80
										Aug.	10	110
										Nov.	7	50

CASH ACCOUNT

DATE		PARTICULARS	FOLIO	AMOUNT DUE		DATE		PARTICULARS	FOLIO	AMOUNT PAID	
19– Jan.	8	Call No 1 40% on 120 sh	2	4800	00	19– Jan.	15	Cash	86	4800	00
June	8	" " 2. 40% " 80 sh	16	3200	00	June	8	"	38	3200	00
Sept.	16	" " 3. 20% " 110 sh	20	2200	00	Sept.	16	"	84	2200	00
				10200	00					10200	00

Form of Dividend Book

THE HAMILTON SOAP COMPANY, LIMITED

Dividend No. 5, 7 per cent., declared June 29, 19—

Names of Shareholders	Addresses	No. of Shares	Amount of Dividend	
Geo. Harris	Dundas, Ont.	40	$280	00
Jno. Lester	Burlington, Ont.	20	140	00
Edw. Frame	Grimsby, Ont.	30	210	00
Chas. Dewar	Beamsville, Ont.	50	350	00
Geo. Gray	Ancaster, Ont.	20	140	00
Chas. Murray	Dundas, Ont.	40	280	00
		200	$1,400	00

Form of Register of Directors

Date Elected		Names	Occupation	Address	Date Retired		Remarks
19— Jan.	30	Henry Green	Merchant	23 Front E., Toronto	19— Jan.	30	
,,	,,	James Black	,,	53 King W., ,,	,,	,,	
,,	,,	Thos. White	,,	31 Yonge St., ,,	,,	,,	
,,	,,	Wm. Gray	,,	134 Yonge St., ,,	,,	,,	
,,	,,	John Brown	,,	43 Bay St., ,,	,,	,,	
19— Jan.	30	Henry Green	Merchant	23 Front E., Toronto	Jan.	30	
,,	,,	James Black	,,	53 King W., ,,	,,	,,	
,,	,,	Wm. Gray	,,	134 Yonge St., ,,	,,	,,	
,,	,,	Alex. Smith	,,	214 Spadina Av. ,,	,,	,,	
,,	,,	Robt. Young	,,	518 Yonge St., ,,	,,	,,	

CHAPTER FOUR

CLASSES OF STOCK

When shares of a company are all of one class, that is, when one part of the shares has no rights over another, they are fittingly described as Ordinary or Common shares.

In the early days of Limited Companies this was the rule. After a time, when the financial condition of some companies made a reorganization necessary, with the introduction of new capital, it was found that the public would not be willing to contribute further capital on the same basis as the capital stock already in the company, but asked for some privilege or preference that might assure them of a return on their investment (in preference to the shares already issued) in consideration of their giving the needed capital. This led to the introduction of Preferred or Preference Stock.

Preference Stock. Preference Stock is stock which takes priority over the ordinary stock of a company to the extent set forth in its Letters Patent of Incorporation, or in the special By-law passed for this purpose. The preference may consist of a stated rate per cent. dividend to be paid to the holders of such stock before any dividends are paid to the holders of ordinary shares, or it may carry with it almost any other special advantage which the directors of the company, or the original incorporators, may have desired to attach to it, including a preference in the repayment if a company is being wound up.

The preference invariably applies to dividends, although, as pointed out, whatever the preference is must be stated in the Charter or By-laws creating it. This does not mean that dividends are guaranteed on the Preference Stock. IF there are profits, and IF these profits, or part of them, are distributed among the shareholders as dividends, the holders of the Preference Stock will have the stated rate of dividend, or as much thereof as it is decided to pay, applied to their shares before anything is given to the common. The fact must be kept in mind that in a corporation the profits are those of the corporation and not those of individual members, as in a partnership. Even if there are profits, the directors are not bound to distribute them. Other conditions may make it inadvisable.

The preference as to dividends does not carry with it a preference as to return of capital or distribution of surplus in winding up. If nothing is said, both classes of shareholders would rank *pro rata*. Where it is desired to give a preference in winding up, this must be stated, and unless, when there is a preference in winding up for the return of capital, it is stated that this is all that will be paid to the holders of preferred shares, they would rank

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with the common shares in the distribution of any surplus remaining if the full amount of the common shares has also been paid.

When there are two or more classes of shares issued, separate Capital Stock Accounts must be kept for each, and, to avoid confusion in the accounts, it is desirable that separate accounts be kept for each class of subscribers. There will also be separate share ledgers for the different classes.

Cumulative Preference Stock. In the case of ordinary Preferred Stock, if the dividends are passed in part or in whole in any period, the arrears cannot be recovered. This condition in the earlier days of Limited Companies led to a further demand on the part of those who were asked to contribute additional capital, that not only should they have a preference, but that if the dividend were not paid in any period, in whole or in part, they should be entitled to the amount of the arrears before anything was paid to the common. This led to the institution of Cumulative Preferred Shares.

Here, again, it should be observed that there is no guarantee of the dividend being paid. Dividends do not accrue as interest does, but depend on profits and on the decision of the directors to distribute those profits. It is the preference that is cumulative, not the liability. If there are arrears of cumulative preferred dividends, no entry is made in the books for them, but a footnote should be added to the Balance Sheet, stating the amount of the arrears, so that all who require the information may obtain it.

Unless otherwise stated, Preferred shares are deemed to be cumulative.

It should be noted also that, while there is no liability for dividends until declared, the moment a cash dividend is declared it creates a current liability and in the Balance Sheet should appear as such. It does not belong to the Proprietorship group, representing permanent investment, or capital funds that will be used, for it means that the current assets will be reduced by the amount of the cash dividend.

Problem. The B Company, Ltd., with an authorized capital of $1,000,000.00, of which $600,000.00 is 7 per cent. Preferred and $400,000.00 Common, all in shares of $100.00 each, issued $400,000.00 Preferred and $100,000.00 Common, all at par, and a call of 20 per cent. on each has been made and paid, except for $5,000.00 on the Preferred.

Record the above and prepare the Balance Sheet.

Solution. Entries (expressed in journal form) assuming that Capital Stock Accounts are to record capital called up.

Subscribers—Preferred	$80,000.00	
To Capital Stock—Preferred		$80,000.00
To record call of 20 per cent. on $400,000.00.		

Subscribers—Common	$20,000.00	
To Capital Stock—Common		$20,000,00
Cash	75,000.00	
To Subscribers—Preferred		75,000.00
Cash	20,000.00	
To Subscribers—Common		20,000.00

THE B COMPANY, LTD.

Balance Sheet
October 31, 19—

Assets

Cash		95,000.00
		$95,000.00

Shareholders' Equity

Capital Stock—		
Preferred	$80,000.00	
Deduct Unpaid Calls	5,000.00	
Paid-up		$75,000.00
Common—Paid-up		20,000.00
		$95,000.00

Mining Shares at a Discount. The shares of trading corporations may not, in most jurisdictions, be issued at a discount. They must be issued for some consideration at at least their par value. Special provision is made by which the shares of mining companies may be issued at a discount, provided that legal requirements are complied with.

Problem. The Georgian Bay Mining Company, Ltd., is incorporated with an authorized capital of $500,000.00, divided into 500,000 shares of $1.00 each. The incorporators receive 200,000 of these shares in payment for their mining property. The rest of the shares are sold at a discount of 40 per cent. Make the journal entries.

Solution. An account called "Share Discount" should be opened and charged with the 40 per cent. discount on the shares issued. As the stock is issued, Share Discount Account will be charged with the difference between the amount at which it is issued and its par value. In the Balance Sheet, Share Discount will not be shown as an asset but deducted from the Issued Capital Account, so that both the nominal and the true capital are shown.

If it is desired to eliminate the share discount from the accounts, it may be done by appropriation out of net profits. The effect is to capitalize so much of the profits as may be applied in that way for, as the discount is written off, the amount of true capital, as shown by Capital Stock less Discount, is greater by the same amount. The method of writing off would be

similar to that applied to Preliminary Expense, but the Discount should not be confused with the Organization Expense in the same account.

The following entries are required by the problem—

1.	Mining Property	$200,000.00	
	To Paid-up Capital Stock		$200,000.00
	For shares issued in payment of Mining Property as per Directors' Minute Book, page —.		
2.	Cash	180,000.00	
	Share Discount	120,000.00	
	To Paid-up Capital Stock		300,000.00
	For sale of shares at 60 cents each, as per by-law No. —.		

The stockholders would be credited in the Share Ledger with the par value of the shares in the usual way.

The Balance Sheet, after giving effect to these entries, is—

THE GEORGIAN BAY MINING COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets		
Cash		$180,000.00
Mining Property		200,000.00
		$380,000.00
Shareholders' Equity		
Capital Stock—		
Subscribed	$500,000.00	
Less: Discount on Shares	120,000.00	
Paid-up Capital		$380,000.00
		$380,000.00

Shares Given as a Bonus. The question of bonus shares constitutes a point on which a great deal of confusion exists. It has been stated already that shares, except in the case of mining companies, cannot be issued at a discount. If they are, the persons to whom they are issued would be liable for the amount of the discount. To avoid confusion, shares of mining companies will not be considered at the moment, which will make clearer the statement that shares must be issued for some consideration and, either at the time or later, fully paid up.

The consideration need not be cash. If legal requirements are complied with, it may be other assets, either tangible or intangible, but it may be for capital expenses, such as organization expense.

Since shares must be issued for some consideration, it follows that they may not be issued as a bonus, and this raises the question of the source of, say, common shares that are given as a bonus with the purchase of preferred shares or bonds.

Shares having been issued for some consideration are then the personal property of the holders, who may dispose of them for any consideration they wish, or give them away. It is persons to whom shares have been issued, perhaps, for intangible values, such as organization expense or goodwill in the sale of companies, that provide the shares used for bonus purposes. The usual plan is that they transfer to a trustee a certain portion of their holdings, with instructions that he is to transfer these in certain proportions to the purchasers of preferred shares or bonds. The amount of capital stock is not affected, and so there are no entries in the financial books for bonus stock. There will be entries in the transfer books and share ledgers, as the shares are transferred from the party giving them to the party receiving them.

The term *Bonus Stock* is used in Great Britain, more particularly, in reference to a stock dividend given in addition to a regular cash dividend. The context will usually make clear the meaning intended.

Problem. The D Company, Ltd., with an authorized capital of $1,000,000.00 in 7 per cent. Preferred shares of $100.00 each, and $600,000.00 Common, also in shares of $100.00 each, issued $200,000.00 of the Common Stock to D in consideration for Patent Rights, and $50,000.00 to E for services in promoting and organizing the company.

The company bought the business of F, receiving net tangible assets of $150,000.00, and issued in payment Preferred shares to an amount of $150,000.00 and Common shares to the amount of $40,000.00. - Goodwill

Of the remaining Preferred shares, 3,000 ($300,000.00) were issued for cash at par, the purchasers receiving as a bonus one share of Common Stock with each five shares Preferred. Commission on shares was covered by the issue of $24,000.00 in Common Stock and $6,000.00 in Cash.

Raise entries and Balance Sheet. Assume that Paid-up Capital, only, is to be recorded and that all payments are made.

Solution. Entries (all given in journal form).

Subscribers—Common	$314,000.00	
To Capital Stock—Common		$314,000.00
To record issue of Common shares.		
Patents	200,000.00	
Organization Expense	50,000.00	
To Subscribers—Common		250,000.00
To record consideration received from D and E.		

Subscribers—Preferred	$450,000.00	
To Capital Stock—Preferred		$450,000.00
Issue of 4,500 shares at $100.00.		
Sundry Assets	150,000.00	
Goodwill	40,000.00	
To Subscribers—Preferred		150,000.00
,, Subscribers—Common		40,000.00
Issue of shares for business acquired.		
Commission on Shares	24,000.00	
To Subscribers—Common		24,000.00
Commission on Shares	6,000.00	
To Cash		6,000.00
Cash	300,000.00	
To Subscribers—Preferred		300,000.00

THE D COMPANY, LTD.

Balance Sheet
March 1, 19—

Assets

Cash	$294,000.00
Sundry	150,000.00
Patents	200,000.00
Organization Expense	50,000.00
Goodwill	40,000.00
Commission on Shares	30,000.00
	$764,000.00

Shareholders' Equity

Capital Stock—Fully paid 7% Preferred	$450,000.00
Common	314,000.00
	$764,000.00

The example on page 49 is somewhat extreme, perhaps, but has been employed to bring out a number of possible sources of the Common shares given as a bonus. Common shares have been issued for Patents, Organization Expense, Goodwill, and as Commission on Shares. Those to whom they were thus issued have agreed to make available a certain portion of their holdings for bonus purposes. As pointed out, these transfers will be recorded in the Transfer Books and Share Ledgers, but the financial records are not in any way affected.

CHAPTER FIVE

CONVERSION OF A PARTNERSHIP INTO A JOINT STOCK COMPANY

The Incorporation of a Going Concern. Many Joint Stock Companies are the development of going concerns which have been taken over and paid for in shares of the new company. Although the principles involved in the bookkeeping connected therewith are exactly the same as those already described, their application introduces certain new features, which require consideration. These are taken up in the problems which follow.

Problem. G. Watson and T. M. Green are partners in a leather business, and convert it into a Joint Stock Company under the name of The Watson-Green Leather Company, Ltd., with an authorized capital of $40,000.00, divided into 400 shares of $100.00 each. The old business is purchased for $20,000.00, to be paid in shares, of which Watson is to get $12,000.00 and Green $8,000.00. The other shareholders pay cash in full of their subscriptions, which are as follows: G. D. Blake, $5,000.00; J. J. Foster, $3,000.00; G. E. Smith, $2,000.00; and W. E. Fowler, $1,000.00.

The firm's Balance Sheet at the time of incorporation stood as follows—

WATSON AND GREEN

Balance Sheet

——— —, 19—

Assets	
Cash in Bank	$1,000.00
Bills Receivable	4,000.00
Accounts Receivable	2,500.00
Merchandise	10,500.00
Plant	8,000.00
	$26,000.00
Liabilities and Capital	
Bills Payable	$7,000.00
Accounts Payable	3,000.00
G. Watson—Capital	10,000.00
T. M. Green—Capital	6,000.00
	$26,000.00

The new company uses the old firm's books. Make the necessary entries therein.

Solution. As there are only a few shareholders, each one may be charged separately in the Subscribers' Account for his subscription and credited with the payments made through the General Ledger. This is done by making the following entries—

(*a*) Subscribers:		
G. Watson	$12,000.00	
T. M. Green	8,000.00	
G. D. Blake	5,000.00	
J. J. Foster	3,000.00	
G. E. Smith	2,000.00	
W. E. Fowler	1,000.00	
To Paid-up Capital		$31,000.00
Stock subscribed as per Subscription Book, and called to be covered by payment at once.		

(*b*) Goodwill	4,000.00	
To G. Watson		2,000.00
,, T. M. Green		2,000.00
Allowance to Watson and Green for Goodwill.		

Watson and Green have turned over their business at an agreed price of $20,000.00, in payment of which they accept shares. According to the Balance Sheet, they already stand credited for $10,000.00 and $6,000.00 respectively. They are now credited for the additional $4,000.00 which is given in consideration of the established reputation and connection of the business. This amount must be entered as Goodwill, and will henceforth appear on the books of the company as an asset.

(*c*) The following entry must now be made in the Cash Book, crediting each subscriber for the cash paid for his shares—

Cash	$11,000.00	
To Subscribers:		
G. D. Blake		$5,000.00
J. J. Foster		3,000.00
G. E. Smith		2,000.00
W. E. Fowler		1,000.00
Cash received in payment of subscriptions.		

The individual accounts of the different shareholders will balance after the three entries explained above have been posted. When the old ledger is used, all accounts should be balanced at the date of taking over the business, the balances carried forward and the accounts *re-headed*. The name of the new company is then written or stamped on the left-hand side of the new heading. The Balance Sheet of the company will then stand as follows—

THE WATSON-GREEN LEATHER COMPANY, LTD.

Balance Sheet

——— —, 19—

Assets

Cash in Bank	$12,000.00
Bills Receivable	4,000.00
Accounts Receivable	2,500.00
Merchandise	10,500.00
Plant	8,000.00
Goodwill	4,000.00
	$41,000.00

Liabilities and Capital

Bills Payable	$7,000.00
Accounts Payable	3,000.00
Capital Stock—Paid-up	31,000.00
	$41,000.00

Problem. Show the entries for the incorporation of the above-named company if new books were opened instead of using the old ones.

Solution. (*a*) Each of the shareholders may be charged for the amount of his subscription—

Subscribers:		
G. Watson	$12,000.00	
T. M. Green	8,000.00	
G. D. Blake	5,000.00	
J. J. Foster	3,000.00	
G. E. Smith	2,000.00	
W. E. Fowler	1,000.00	
To Paid-up Capital		$31,000.00
Stock subscribed, as per Subscription Book, called up for payment at once.		

(*b*) The firm of Watson and Green should be credited for the assets turned over by them to the new company, and debited for the liabilities assumed by the company. The $4,000.00 for Goodwill is included among the assets. The difference will be the net amount to be paid the firm for their interest in the business, which they have agreed to take in stock. One entry may be made as follows to cover both the assets and liabilities, and show the net amount due Watson and Green—

Cash	$1,000.00	
Bills Receivable	4,000.00	
Accounts Receivable	2,500.00	
Merchandise	10,500.00	
Plant	8,000.00	
Goodwill	4,000.00	
To Bills Payable		$7,000.00
,, Accounts Payable		3,000,00
,, Watson and Green		20,000.00
Assets taken over and liabilities assumed by the company in taking over the business.		

(*c*) The firm of Watson and Green, having arranged that the stock would be allotted to them individually instead of as a firm, the following entry is made, crediting each partner with his equity—

Watson and Green	$20,000.00	
To G. Watson		$12,000.00
,, T. M. Green		8,000.00
Allotment of stock in settlement, as per agreement.		

(*d*) An entry must be made in the Cash Book crediting each subscriber with the cash paid for his shares—

Cash	$11,000.00	
To Subscribers—		
G. D. Blake		$5,000.00
J. J. Foster		3,000.00
G. E. Smith		2,000.00
W. E. Fowler		1,000.00
Payment in full of shares allotted.		

Problem. In the event of entirely new books being used by the above company, what entries would be required to close the books of the firm of Watson and Green properly?

Solution. The firm received $4,000.00 more for the business than the aggregate of the partners' capital accounts, as shown by the Balance Sheet given in the question. Presumably they have been sharing profits equally as, according to the terms of incorporation, each receives half of this extra amount, which is a clear profit to the partners and represents the value of the Goodwill of the business. This has not yet appeared in the firm's books, but is brought into them by the following entry—

Goodwill	$4,000.00	
To G. Watson		$2,000.00
,, T. M. Green		2,000.00
To credit each partner for half of the value of the Goodwill.		

Entries should then be made as follows, covering the sale of the business and settlement therefor—

(*a*)	Watson-Green Leather Co., Ltd.	$30,000.00	
	To Cash		$1,000.00
	,, Bills Receivable		4,000.00
	,, Accounts Receivable		2,500.00
	,, Merchandise		10,500.00
	,, Plant		8,000.00
	,, Goodwill		4,000.00
	Assets transferred to Watson-Green Co. on taking over the business.		
(*b*)	Bills Payable	7,000.00	
	Accounts Payable	3,000.00	
	To Watson-Green Leather Co., Ltd.		10,000.00
	Liabilities assumed by the Watson-Green Co. on taking over the business.		

(*c*)	Shares of Watson-Green Leather Co. Stock	$20,000.00	
	To Watson-Green Leather Co., Ltd.		$20,000.00
	Shares received by the firm in settlement of the transfer of the business as per agreement.		
(*d*)	G. Watson	12,000.00	
	T. M. Green	8,000.00	
	To Shares of Watson-Green Leather Co., Stock		20,000.00
	Shares allotted to Watson and Green respectively in settlement of their respective interests, as shown by their capital accounts.		

Problem. C. R. Jones and J. W. Wilson are partners in the printing business, sharing gains and losses equally. Their affairs stand as follows—

JONES AND WILSON

Balance Sheet

——— —, 19—

Assets	
Cash	$2,000.00
Bills Receivable	3,400.00
Accounts Receivable	1,200.00
Merchandise	600.00
Plant	10,000.00
	$17,200.00
Liabilities and Capital	
Bills Payable	$6,000.00
Accounts Payable	2,000.00
C. R. Jones—Capital	6,900.00
J. W. Wilson—Capital	2,300.00
	$17,200.00

They convert their business into a Joint Stock Company, incorporated with an authorized capital of $25,000.00, under the name of the Hamilton Printing Company, Ltd. The other subscribers are: D. Gray, $5,000.00; R. Smith, $4,000.00; and T. F. Wood, $2,000.00. These pay cash in full of their subscriptions.

It is agreed that the plant will be taken over at a valuation of $8,500.00, the merchandise at $500.00, and the notes and book debts at 10 per cent. discount. Jones and Wilson take fully paid-up shares in settlement of their respective interests, cash being paid them in lieu of the fractional portion of a share.

Make the opening entries in the company's new books.

Solution. In dealing with this question, the plant and merchandise should be entered up at exactly what they cost the company. Bills receivable and book debts are rarely ever considered worth 100 per cent., but, nevertheless, must appear in the books at their face value. The discount spoken of in the problem is not deducted from the debit side of the several accounts, but is set aside as a "Reserve" against which to charge any losses that may occur from this source. It should not be entered to the credit of Profit and Loss, as that would make it appear that the company had realized a profit equal to 10 per cent. of the face value of the notes and accounts receivable, which is not necessarily the case. Such deductions from accounts or notes should always be considered as a Reserve, to offset possible losses in realizing. It will be seen that the assets, which are listed at $17,200.00, bring only $15,140.00, thus resulting in a loss of $2,060.00 to the firm of Jones and Wilson. This, being shared equally, reduces the capital of Jones to $5,870.00, and the capital of Wilson to $1,270.00. Jones will therefore get $5,800.00 stock and $70.00 cash, while Wilson will get $1,200.00 stock and $70.00 cash. The entries to be made are as follows, cash items passing through the Cash Book—

1.	Cash	$2,000.00	
	Bills Receivable	3,400.00	
	Accounts Receivable (mentioned separately)	1,200.00	
	Merchandise	500.00	
	Plant	8,500.00	
	To Reserve for Bad Debts		$460.00
	,, Bills Payable		6,000.00
	,, Creditors (mentioned separately)		2,000.00
	,, C. R. Jones		5,870.00
	,, J. W. Wilson		1,270.00
	Assets taken over and liabilities assumed by the new company on taking over the business.		
2.	C. R. Jones	5,800.00	
	J. W. Wilson	1,200.00	
	To Paid-up Capital		7,000.00
	Shares allotted them re transfer of business.		
3.	C. R. Jones	70.00	
	J. W. Wilson	70.00	
	To Cash		140.00
	Cash paid in lieu of fractional part of shares due them.		
4.	Subscribers—		
	D. Gray	5,000.00	
	R. Smith	4,000.00	
	T. F. Wood	2,000.00	
	To Paid-up Capital		11,000.00
	Subscriptions, as per Stock Book.		

5. Cash	$11,000.00	
To Subscribers—		
D. Gray		$5,000.00
R. Smith		4,000.00
T. F. Wood		2,000.00
Payment in full of subscriptions.		

Instead of opening accounts with Jones and Wilson as individuals, the entries affecting these might be passed through a firm account as follows—

1. Various Assets (separately)	$15,600.00	
To Reserve for Bad Debts		$460.00
,, Liabilities (separately)		8,000.00
,, Jones and Wilson		7,140.00
Assets taken over and liabilities assumed in taking over the business of Jones and Wilson, as per agreement.		
2. Jones and Wilson	7,000.00	
To Capital Stock		7,000.00
Shares allotted as follows, re transfer of business as per agreement: C. R. Jones, 58 shares; J. W. Wilson, 12 shares.		
3. Jones and Wilson	140.00	
To Cash		140.00
Cheques issued as follows, in lieu of fractional portion of shares as per agreement: C. R. Jones, $70.00; J. W. Wilson, $70.00.		

Entries (4) and (5) would remain unchanged.

This is the more usual method, since the transaction is with the firm as a whole, rather than with the individual partners.

Problem. A Joint Stock Company takes over, as a going concern, the business of R. Thompson. The purchase price agreed upon is $500,000.00, payable as follows—

> 2,500 shares of Common Stock of $100.00 each;
> 1,250 shares of 6 per cent. Preferred Stock at $100.00 each;
> The balance in Cash.

The assets consist of Land and Buildings, $80,000.00; Plant and Machinery, $210,000.00; Stock-in-Trade, $185,000.00; Accounts Receivable, $155,000.00; Bills Receivable, $100,000.00. The liabilities are: Accounts Payable, $135,000.00; Bills Payable, $95,000.00.

Make the necessary entries, in journal form, to record the transactions in the financial books of the company.

Solution. The following are the journal entries required—

1.	Bills Receivable	$100,000.00	
	Accounts Receivable	155,000.00	
	Stock-in-Trade	185,000.00	
	Plant and Machinery	210,000.00	
	Land and Buildings	80,000.00	
	To Accounts Payable		$135,000.00
	,, Bills Payable		95,000.00
	,, R. Thompson		500,000.00
	Assets and Liabilities taken over from R. Thompson, under agreement of this date, transferring his business to the company. See Minute Book, page —.		
2.	R. Thompson	500,000.00	
	To Paid-up Capital—Common		250,000.00
	,, Paid-up Capital—6 per cent. Preferred		125,000.00
	,, Cash		125,000.00
	Issue of 2,500 shares of Common Stock, 1,250 shares of 6 per cent. Preferred Stock and payment of $125,000.00 Cash in full settlement of transfer of business of R. Thompson, as per agreement. See Minute Book, page —.		

Problem. If, in the foregoing question, the consideration for the transfer of the business had been $525,000.00, consisting of 2,750 shares of Common Stock, 1,250 shares of 6 per cent. Preferred, and $125,000.00 Cash, what entries would have been made?

Solution. The additional $25,000.00 paid for the business over and above its net assets would be charged to Goodwill and credited to R. Thompson in Entry No. 1, while in Entry No. 2, Thompson would be charged and Paid-up Capital—Common, credited with the extra $25,000.00 stock issued. The entries would then appear as follows—

1.	Bills Receivable	$100,000.00	
	Accounts Receivable	155,000.00	
	Stock-in-Trade	185,000.00	
	Plant and Machinery	210,000.00	
	Land and Buildings	80,000.00	
	Goodwill	25,000.00	
	To Accounts Payable		$135,000.00
	,, Bills Payable		95,000.00
	,, R. Thompson		525,000.00
	Explanation here.		

2. R. Thompson	$525,000.00	
To Paid-up Capital—Common		$275,000.00
,, Paid-up Capital—6 per cent. Preferred		125,000.00
,, Cash		125,000.00
Explanation here.		

Problem. What entry would have been made if the consideration for the transfer of the business had been 2,500 shares of Common Stock, 1,250 shares of 6 per cent. Preferred, and $110,000.00 Cash?

Solution. In that event, the company would have purchased net assets carried in the books at $500,000.00, for which they would have to pay only $485,000.00, or $15,000.00 less. This $15,000.00 should be credited to a special Reserve Account, not to Profit and Loss. To credit it to the latter account would give a false idea of the profit-earning power of the business when the annual statements were prepared. It is not a profit. A company cannot earn profits before organization, and the price paid is what the business is agreed to be worth. This difference may be written off the fixed assets if it is not necessary to hold it as a reserve against current assets. Assume in this case that it is to cover bad debts.

1. Bills Receivable	$100,000.00	
Accounts Receivable	155,000.00	
Stock-in-Trade	185,000.00	
Plant and Machinery	210,000.00	
Land and Buildings	80,000.00	
To Accounts Payable		$135,000.00
,, Bills Payable		95,000.00
,, R. Thompson		485,000.00
,, Reserve for Bad Debts		15,000.00
Explanation here.		

2. R. Thompson	485,000.00	
To Paid-up Capital Stock—Common		$250,000.00
,, Paid-up Capital Stock—6 per cent. Preferred		125,000.00
,, Cash		110,000.00
Explanation here.		

CHAPTER SIX

PROFITS, APPROPRIATIONS, AND BALANCE SHEET

General Principles. The same principles, in determining the amount of Profits or Losses, apply in the case of a Limited Company as in any other form of business organization. Differences will arise, however, in the application of the Profit.

Profits in a Partnership. In a partnership, profits are divided in definite proportions, according to agreement, or, lacking any agreement on the point, equally. The profits in a firm belong to the proprietors, and, after the Net Profit has been determined and brought down in the appropriation section of the Profit and Loss Account, or in a separate Appropriation Account, the amount to which each partner is entitled is transferred to his credit.

Profits in a Limited Company. In a Limited Company (Corporation) the personal element is lacking. The profits belong to the corporation and not to the shareholders as individuals. There is no such thing then as crediting the various shareholders with their share of the profits. At this point it should be observed that there is a real difference between finding the amount of Net Profit and appropriating the profit after it is found. Each period will have its own operating accounts, that is, there will be separate operating accounts for each period, so that the current Profit and Loss Account is not continuous. Its purpose is to determine the amount of Net Profit for its own period.

Profit Appropriations. In a Limited Company, the current Profit and Loss Account balance, representing Net Profit, is transferred to a Profit and Loss Appropriation Account. In that account will be shown the purposes, if any, to which the earned profits are to be applied. The corporation, through its directors, decides how the profits shall be appropriated.

Only a Part of Profits Distributed. It will be found, usually, in any business, that the profits will not be all drawn out. In a Firm it would be expected that a partner would draw out less than his credits for salary, profits, etc. In a Sole Proprietorship the same idea should prevail. In a Limited Company that is well managed the directors will endeavour to leave a portion of the profits within the business, that is, they reserve from distribution, to be kept within the business, a portion of the profits which, being represented by current assets, adds to the funds as Working Capital.

Reserve Fund. Since the balance in the Appropriation Account at any time indicates the amount available for appropriation, for dividends or other purposes, the plan followed, when it is intended that a portion of the

profits is to be retained to provide further Working Capital and to protect the capital in case of future losses, is to transfer the amount to be so retained from the Appropriation Account to an account called Reserve, or General Reserve, or Reserve Fund, or, as termed by some financial institutions, Rest.

To understand the relation of this it is necessary to remember always that profits are represented by an increase in assets, and they are first expressed in the form of current assets, so that reserving a portion of the profits from distribution does actually add to the Working Capital. The actual fund is in the form of assets, but the amount need not be, and seldom is, segregated in any definite form. The account, Reserve or Reserve Fund, shows the amount so reserved in just the same way as the Capital Stock Account or the Capital Account of any other business shows the amount of Capital, while the actual assets representing that Capital are shown on the other side of the Balance Sheet.

Different Appropriations. Appropriations may be made for any legal purpose desired. When appropriations are made for dividends, the transfer is made from the Appropriation Account to the credit of the Dividend Account, and if there are dividends on different classes of shares, or both Cash and Stock dividends, then to the credit of the separate Dividend Accounts. It is not desirable that more than one dividend be recorded in one Dividend Account. Each account should be the source of one kind of information. It has been pointed out that there is no liability at all for a dividend until it is declared, but the moment it is declared a cash dividend constitutes a current liability. The amount is then owing to the shareholders.

Cash Dividends, when Declared, a Current Liability. Frequently students in Corporation Accounts show unpaid dividends in the group with Capital Stock, Accumulated and Unappropriated Profits. In doing so, the fact is overlooked that these amounts set aside for dividends will be met out of the current assets in the very near future, and are not amounts that will be used as capital funds in operation. It is important to see that they are included among current liabilities.

Dividend List. When the dividend is declared, a Dividend List or Book will be made up, showing the names of the shareholders of each class of shares, their addresses, the number of shares and amount of the dividend at the rate declared. When these amounts are extended and totalled they should equal the amount of the appropriation for that dividend. An illustration of the form of Dividend Book has been given with other forms.

Transfers from Reserve Fund. If a portion of the Reserve Fund is to be applied to dividends, the amount required will be transferred back from the Reserve Fund Account to the Appropriation Account. All voluntary appropriations are recorded in that account and should not be made direct from any other.

Advantages of Reserve Fund. The reserving of profits within the business, and appropriating the amount to the credit of Reserve or Reserve Fund, has two advantages in particular—

1. The amount stands as a protection against impairment of capital through losses. Should a year's operations result in a deficit, they may be overcome by a transfer from the Reserve Fund, and, as long as the deficit is not greater than the Reserve Fund, there will be assets equal at least to the liabilities and the paid-up capital.

2. Should profits in any year be insufficient to meet dividend requirements, and the working capital position of the business will permit, an amount may be transferred back from the Reserve Fund to the Appropriation Account and appropriated for dividends. In this way the continuity of dividends may be preserved, should operations in the succeeding year give better results. In this sense the Reserve Fund is sometimes referred to as dividend insurance.

INCOME TAX. The provision for Income Tax, since it is based on the amount of Net Profit, is not itself an operating expense, but a compulsory appropriation of part of the profit. As an appropriation it would naturally appear as a charge in the Appropriation Account (and as it is compulsory it is a first charge) and the Reserve for Income Tax be set up. Since it is compulsory, however, and appropriations are generally thought of as being voluntary, it would seem to be reasonable that after the Net Profit has been brought down in the Profit and Loss Account, the provision for Income Tax may be charged against that before the transfer is made to the Appropriation Account, where voluntary appropriations will be recorded. The effect of this latter method is that the amount transferred to the Appropriation Account is available for voluntary appropriations. At the same time, since the provision for Income Tax is an appropriation out of Net Profit, it is logically the first charge in the Appropriation Account.

DIVIDEND RESERVE. It is sometimes a feature, when there is Preferred stock, that the by-laws will provide that, to assure the regularity of dividends, a certain portion of the profits shall be appropriated to a Dividend Reserve Account before dividends are declared on the Common. As long as the amount of the Dividend Reserve remains in the business it provides Working Capital, just as the amount shown in Reserve Fund does, but the purpose is to have an amount definitely set apart to be appropriated for Preferred Dividends, should the need arise, without drawing on the Reserve Fund, the amount of which is intended to remain in the business, although it may be used to meet emergencies and to protect the capital in the event of losses.

RESERVE FOR PREMIUM ON REDEEMABLE OR CONVERTIBLE BONDS OR SHARES. When shares of a certain class, or bonds are issued with the provision that they are redeemable after a certain date at an amount above par, or are convertible at a figure above par into junior securities, a proportionate amount should be appropriated from the net profits each year during that period, so that when the time of redemption or conversion comes, the excess over par may be charged to that Reserve. It should not be overlooked that the charge is made in the Appropriation Account and not in the current Profit and Loss Account, for the provision is not an operating expense.

WRITING DOWN INTANGIBLE ASSETS. If capital expense, such as Organization Expense or Commission on Shares, is to be written off, it will be by an appropriation out of Net Profit and not as a charge in the current Profit and Loss Account. The amounts will therefore be recorded as appropriations, and the same would apply if an intangible asset, such as Goodwill, were being written down. These charges are not related to operations.

SINKING FUND. Where it is desired to build up a Sinking Fund without reducing working capital for operations, the amount required would be earmarked and retained within the business by appropriating out of Net Profit to a Sinking Fund Reserve. This will be discussed in detail later, under Sinking Funds.

BALANCE UNAPPROPRIATED. The above examples will be sufficient to bring out the difference between the charges against Revenue, which must be made before the Net Profit or Loss is determined, and the appropriation of profits after the amounts have been determined. It is unlikely that the full amount of Net Profit will at any time be appropriated, so that a balance will remain at the credit of the Appropriation Account. This is available for appropriation when desired, which is very convenient as if, in the next year, the amount of Net Profit available for appropriation is lower than dividend requirements there may be sufficient with the balance that had not been appropriated in the previous year.

SURPLUS. Sometimes the Appropriation Account is referred to as Surplus. The term Surplus, however, is a very broad one. Any equity of shareholders over and above the Paid-up Capital constitutes surplus. This may also be expressed by defining Surplus as the excess of the value of the Assets over Liabilities and Paid-up Capital. Thus there may be a capital surplus provided by premium on shares or by profits on the disposal of fixed assets, etc., while, as has been shown, appropriations of Net Profit may have been made to retain amounts within the business, as shown by Reserve Fund, Sinking Fund Reserve, Dividend Reserve, or perhaps Contingent Reserve, etc. For this reason, it is submitted that it is desirable to give a title to the account in which the appropriations are recorded, to indicate that the amount in such an account is that part of the surplus which is intended as available for appropriations, whether it be to another section of Surplus, or for dividends the amount of which is to be paid out, or for other purposes, such as writing down intangible assets or capital expenses.

Revenue Surplus *v.* Capital Surplus

GENERAL DISTINCTION. The distinction referred to between a Revenue or Earned Surplus and Capital Surplus should be carefully observed. A Revenue Surplus or Earned Surplus is built up by withholding from distribution a portion of the net profits derived from ordinary operation. Capital Surplus does not have its source in operations. If shares are issued at a premium, the legal or stated capital is the Par Value and any excess of capital contribution above that amount constitutes a Capital Surplus.

PROFIT ON FIXED ASSETS. If a trading or industrial concern sells a fixed asset at a profit, this profit is not derived from the ordinary operations, but from the disposal of a fixed or capital asset, and may be properly termed a capital surplus. As will be brought out later when discussing shares without par value, the law in many cases permits a division of the amount obtained and only part thereof is set up in the accounts as a credit to Capital Stock, the balance of the amount received thus being separated and constituting a capital surplus. All amounts that constitute a capital surplus should be excluded from the operating accounts, and would be better shown under their own titles and on the Balance Sheet would appear as Capital Surplus. There is no Income Tax on such amounts, since Income Tax is based on operating earnings, not on accretions to capital.

AS TO THE APPLICATION OF CAPITAL SURPLUS, the treatment already suggested for premium on shares may be applied. The amount should be first applied to cover any capital expenses or losses outside of operation. If this is done, and there is nothing in the charter or by-laws that would prohibit, there appears to be nothing in law to prevent any amount remaining being appropriated for dividends. The advisability of such appropriations for dividends may, however, be another matter.

The example that follows will illustrate some of the features to which reference has been made.

Problem. From the information submitted, prepare Trading, Profit and Loss, and Appropriation Accounts and Balance Sheet of the Dash Trading Company Ltd., at December 31, 19—.

Trial Balance

December 31, 19—

Debit Balances

Cash in Bank	$2,800.00
Petty Cash	50.00
Accounts Receivable	14,000.00
Bills Receivable	16,000.00
Merchandise, Jan. 1, 19—	16,000.00
Land	6,000.00
Buildings	40,000.00
Furniture and Equipment	4,750.00
Goodwill	11,000.00
Purchases	190,000.00
Freight and Duty—Purchases	17,800.00
Wages	12,000.00
Salaries	7,200.00
Taxes	1,640.00
Insurance	520.00
General Expense	4,360.00
Cash Discounts	1,400.00
Interest on Mortgage	900.00
	$346,420.00

Continued on next page

Credit Balances

Accounts Payable	$10,500.00
Bills Payable	9,300.00
Bank Loan	2,000.00
Mortgage—6 per cent.	15,000.00
Cash Discounts	1,450.00
Sales	250,000.00
Allowance for Bad Debts	600.00
Allowance for Depreciation—Buildings	4,000.00
Allowance for Depreciation—Equipment	950.00
Capital Stock—7 per cent. Cum. Preferred	30,000.00
Capital Stock—Common	15,000.00
Reserve Fund	6,600.00
Profit and Loss Appropriation, Balance	1,020.00
	$346,420.00

Inventory of Merchandise, December 31, 19—, $15,000.00. There are Wages Unpaid, $200.00, and Taxes, $160.00. Of Insurance Premiums paid, $100.00 is unexpired. Provide for Depreciation in Buildings at 2½ per cent., on Furniture and Equipment at 10 per cent. Add sufficient to the Allowance for Bad Debts to bring it up to 5 per cent. of Accounts and Bills Receivable. Provide, by appropriation, for Dominion Income Tax of 8 per cent. on Net Profits in excess of $2,000.00. The Cumulative Dividend for the previous year had been only 4 per cent., and $3,900.00 is to be distributed in dividends at this time. Show the appropriations. Transfer $6,000.00 to Reserve Fund. The Bank Loan is new and no interest has accrued.

Solution—

Dr. *Trading Account* *Cr.*

For the year ending December 31, 19—

Stock, January 1	$16,000.00	Sales	$250,000.00
Purchases	190,000.00	Stock—Inventory, Dec. 31	15,000.00
Freight and Duty on Purchases	17,800.00		
Gross Profit	41,200.00		
	$265,000.00		$265,000.00

Or

Stock, January 1	$16,000.00	Sales	$250,000.00
Purchases	190,000.00		
Freight and Duty on Purchases	17,800.00		
	223,800.00		
Less—			
Stock Inventory, Dec. 31	15,000.00		
Cost of Goods Sold	208,800.00		
Gross Profit	41,200.00		
	$250,000.00		$250,000.00

Dr. *Profit and Loss* *Cr.*

Wages	$12,200.00	Gross Profit—Trading	$41,200.00
Salaries	7,200.00	Cash Discounts	1,450.00
Taxes	1,800.00		
Insurance	420.00		
General Expense	4,360.00		
Depreciation—			
Buildings	1,000.00		
Furniture and Equipment	475.00		
Provision for Bad Debts	900.00		
Cash Discounts	1,400.00		
Balance—Operating Profit	12,895.00		
	$42,650.00		$42,650.00
Interest on Mortgage	$900.00	Balance—Operating Profit	$12,895.00
Balance—Net Profit	11,995.00		
	$12,895.00		$12,895.00
		Balance—Net Profit	$11,995.00

Dr. *Profit and Loss Appropriation* *Cr.*

19—			19—		
Dec. 31	Income Tax—		Jan. 1	Balance	$1,020.00
	Dominion	$799.60	Dec. 31	Net Profit for year	11,995.00
,, 31	Dividend—				
	Cum. Pref. 10%	3,000.00			
	Common 6%	900.00			
,, 31	Reserve Fund	6,000.00			
,, 31	Balance	2,315.40			
		$13,015.00			$13,015.00
			Jan. 1	Balance	$2,315.40

Dr. *Income Tax Payable—Dominion* *Cr.*

			19—		
			Dec. 31	Profit and Loss Appropriation J.	$799.60

Dr. *Dividend—Cumulative Preferred* *Cr.*

			19—		
			Dec. 31	Profit and Loss Appropriation J.	$3,000.00

Dr. *Dividend—Common* *Cr.*

			19—		
			Dec. 31	Profit and Loss Appropriation J.	$900.00

Dr. *Reserve Fund* *Cr.*

19—			19—		
Dec. 31	Balance	$12,600.00	Jan. 1	Balance	$6,600.00
			Dec. 31	Profit and Loss Appropriation	6,000.00
		$12,600.00			$12,600.00
			19—		
			Jan. 1	Balance	$12,600.00

Journal entries would be made to transfer the working account amounts to Trading and Profit and Loss. These are similar to the same entries in any other form of business organization.

The entries for the transfer of Net Profit and for the appropriations, also in the General Journal, are—

19—			
Dec. 31	Profit and Loss	$11,995.00	
	To Profit and Loss Appropriation		$11,995.00
	To transfer the Net Profit for the year from the current Profit and Loss Account to the Appropriation Account.		
	Profit and Loss Appropriation	10,699.60	
	To Income Tax Payable—Dominion		799.60
	,, Dividend—Cum. Pref. 10%		3,000.00
	,, Dividend—Common 6%		900.00
	,, Reserve Fund		6,000.00
	To record appropriations made from profits available.		

Operating v. Net Profit. On referring to Profit and Loss Account as given, it will be seen that the balance has been brought down before the interest on the mortgage was debited to the account. This is important. The amount earned by the corporation was $12,895.00. This was earned by all the capital employed, including the amount borrowed, and the amount of profits that had remained within the business during the year. The Operating Profit, expressed as a percentage of all the capital employed, gives the rate of earning power during the year.

While this amount is the profit earned, it is not the amount that is available for appropriation by the corporation, for there must be charged against it the interest on its loans. The mortgage has been outstanding during the year, and the interest, while not an operating charge in the same sense as the other items included in the Profit and Loss, represents the cost of obtaining further capital with which to operate. This must be provided for before the Net Profit belonging to the corporation can be stated. This Net Profit, $11,995.00, represents the return on the shareholders' equity.

Earning Rate *v.* Rate of Return on Shareholders' Equity. It will be observed from the calculations that follow that the return on the shareholders' equity is higher than the rate of earning power. This is accounted for by the fact that money was borrowed at 6 per cent., whereas it earned 19.07 per cent. and the excess over the 6 per cent. is a benefit to the shareholders.

If the Profit and Loss Account were not balanced off at the Operating Profit and before interest on long term loans is charged, the real earning power of the business would be obscured.

Total Capital employed is represented by: Preferred Stock, $30,000.00 + Common, $15,000.00 + Reserve Fund, $6,600.00 + Unappropriated Profits, $1,020.00 + Mortgage Loan, $15,000.00, or a total of $67,620.00.

$$\text{Earning rate} = \frac{1289500}{6762000} \text{ of } 100 = 19{\cdot}0698 + \%$$

Shareholders' Equity during the year was represented by: Preferred Stock, $30,000.00 + Common, $15,000.00 + Reserve Fund, $6,600.00, and Unappropriated Profits, $1,020.00, or a total of $52,620.00, and the return on this, before Income Tax, was—

$$\frac{1199500}{5262000} \text{ of } 100 = 22{\cdot}795 + \%$$

If these percentages were based on the profits after Income Tax, the calculation would appear as below—

$$\text{Earning rate} = \frac{1209540}{6762000} \text{ of } 100 = 17{\cdot}887 + \%$$

$$\text{Return on Shareholders' Equity} = \frac{1119540}{5262000} \text{ of } 100 = 21.275 + \%$$

A Company Balance Sheet

In order to show the relation of the different items given in or arising out of the simple problem used as an example to illustrate Appropriations the Balance Sheet is given on page 70.

Importance of Form. When preparing a Balance Sheet, a thought that must be uppermost in the mind is that a Balance Sheet is intended to give all the information possible relative to the financial condition of the corporation at a certain time. It is not sufficient to set it up in the form of a Trial Balance, for the object is not merely to meet the bookkeeping idea of a perfect balance. To provide all information possible it is necessary that the various classes of Assets and of Liabilities, as well as the items affecting Shareholders' Equity, be grouped and the amount of each group set out.

THE DASH TRADING COMPANY, LTD.

Balance Sheet

December 31, 19—

Assets

Current—			
Cash in Bank		$2,800.00	
Petty Cash		50.00	
Accounts Receivable	$14,000.00		
Bills Receivable	16,000.00		
	30,000.00		
Less : Reserve for Bad Debts	1,500.00	28,500.00	
Stock-in-Trade		15,000.00	$46,350.00
Deferred Charges—			
Unexpired Insurance			100.00
Fixed—			
Land		6,000.00	
Buildings	40,000.00		
Less : Reserve for Depreciation	5,000.00	35,000.00	
Furniture and Equipment	4,750.00		
Less : Reserve for Depreciation	1,425.00	3,325.00	44,325.00
Goodwill			11,000.00
			$101,775.00

Liabilities and Capital

Current—		
Accounts Payable	$10,500.00	
Bills Payable	9,300.00	
Bank Loan	2,000.00	
Accrued Charges—		
Wages	200.00	
Taxes	160.00	
Income Tax—Dominion	799.60	
Dividends Unpaid—		
Preferred	3,000.00	
Common	900.00	$26,859.60
Fixed or Deferred—		
Mortgage Payable		15,000.00
Shareholders' Equity—		
Capital Stock—Subscribed and Paid—		
Preferred—7% Cumulative	30,000.00	
Common	15,000.00	
Reserve Fund	12,600.00	
Unappropriated Profits	2,315.40	59,915.40
		$101,775.00

Working Capital is represented by the excess of Current Assets over Current Liabilities.

Current Assets are those assets which either exist in the form of Cash or are expected to be realized in Cash in the ordinary course of business. It is not the nature of the asset, but its relation, that determines its place. Money borrowed, say, by an issue of bonds, for the purpose of acquiring fixed assets is a Fixed Asset, and not Current. The temporary investment of current funds, the amount of which will be later used in the ordinary course of business, would constitute a Current Asset, but the investment of funds for acquiring fixed assets later on, or a sinking fund investment for the discharge of a mortgage debt, would not be a Current Asset.

Current Liabilities are those maturing in the near future and which will be met out of Current Assets. Mortgage bonds due in the future do not constitute a Current Liability, but the amount due within the current or ensuing period would be a Current Liability.

The amount appropriated for Income Tax appears as a Current Liability, for it must be met shortly out of Current Assets. The same is true of Dividends appropriated and also of Accrued Charges and Bank Loans.

In the Balance Sheet illustrated herein, the Working Capital can be readily determined, since the totals of the Current Assets and of the Current Liabilities are clearly stated.

The relation between the Tangible Fixed Assets and the Mortgage indebtedness is also apparent at a glance. Goodwill is a fixed asset, but intangible, and has no real value for security purposes. For this reason, Goodwill and any other Intangibles are shown after the total of Tangible Fixed Assets has been extended. The relation of Fixed Assets to Paid-up Capital is also important.

The Shareholders' Equity is represented by the Paid-up Capital Stock and the Surplus, which in this case is represented by the amounts at the credit of Reserve Fund and Appropriation Account.

Special Reserves are Deducted from the assets to which they relate. They are not liabilities in the sense of representing amounts to be paid. They do not constitute a part of the shareholders' equity, except in so far as the provisions may be greater than necessary, which is not to be assumed. The reserves enable the assets to be carried at their face amounts or cost, and this amount to be adjusted in the Balance Sheet to show the value at which they are being carried in the books. To show the reserves apart on the Liabilities side would leave the assets recorded on the Assets side at more than their estimated value. It is true that the reserves are estimates, but it may be inferred that to show the estimated net value in one amount is safer than to show on one side an amount that is greater than the estimated real value, only to be offset by negative amounts stated separately on the other side.

CHAPTER SEVEN

SHARES WITHOUT PAR VALUE

General Features

In the preceding discussion of shares of capital stock it was assumed in every case that the shares had a Nominal or Par Value. It is desirable that this feature be thoroughly understood as a background for the discussion of shares without par value.

Factors Affecting Real Value of Shares. Assume that a company has capital subscribed and fully paid, 5,000 shares of $100.00 each, or $500,000.00, and, leaving out of consideration any expense of organization, that the full amount is on hand when they commence business. At that moment it may be said that the shares have a book value, and apparently a real value, of $100.00 each. When operations are commenced, two forces at once get into action. One of these is the effort to earn profits through the business transactions. Such profits would tend to increase the shareholders' equity in the corporation. The other force involves the expense of carrying on the business and, possibly, losses in transactions, which expenses and losses tend to decrease the shareholders' equity. At the end of a period the accounts recording the various items in these divisions are brought together to determine which of these forces has overcome the other, that is, whether there is a Net Profit or a Net Loss. It will be observed, however, that the actions of these forces commence as soon as operations are commenced, and that there will, at any time in the period, have been an excess of profits over expenses and losses, or an excess of expenses and losses over profits.

Real Value v. Par Value. The value behind the shares does not remain constant, but is continually changing, so that the par value, if it were the true value at the beginning, almost immediately ceases to reflect the real value, and so, while the nominal value continues to be the same, the real value does not remain constant.

Par Value, Book Value, Market Value. The market value of shares is determined largely by the earning power of the corporation, and may be something quite different again from the book value. There may then be the condition, say at the end of one year, that while the shares had a real value and a book value of $100.00 at the beginning, their book value at the end of the year is either greater or less than $100.00, while the market value may be something different again.

Possible Wrong Impressions. This draws attention to the fact that the par value may not have any direct relation to the true value or to the

book value. Purchasers of shares at, say, par of $100.00, are apt to believe that, because that value is printed on the certificates and shown in the charter, it represents a real value, so that their attention is directed to something that may give a wrong impression as to value.

Real Significance of Shares. In the illustration taken there are 5,000 shares. If a person holds one share, he has a 1/5000 interest in the equity behind the shares. If he holds ten shares, he has a 1/500 interest in the equity. To determine the book value of the shares, then, it is necessary to divide the total equity behind the shares by the number of shares, and the fact of the shares having a par value does not enter into this calculation. Shares, then, may be referred to as merely participation certificates.

Shares were originally given a par value in company charters so that the Authorized Capital could be stated in dollars and cents. It has been found, through years of experience, by corporations, that this need not be a vital factor in stating Authorized Capital, and that the attention of a shareholder will be more directly turned to real value if the par value feature is omitted altogether. This led to the introduction of shares without par value.

Advantages and Disadvantages

The advantages claimed for No Par shares may be referred to in part at this point.

Some Advantages to the Corporation.

1. A company may require funds when its shares are quoted at less than par on the market. It would be illegal to issue shares at a discount. No Par shares may be issued at market price, whatever that may be, or at the price determined by the directors of the issuing company.

2. There is greater flexibility, since shares may be issued at different prices to meet changed conditions.

3. Since shares without par value may be issued at a price to be determined, and for a small amount, the feature of uncalled and unpaid amounts is not likely to be prevalent.

4. They are better adapted for distribution among employees.

5. They facilitate reorganization since, if a company shows a deficit and its capital is thus impaired, the issue of No Par shares instead of the former shares with a par value, for the net value of the assets, may be acceptable to the shareholders. This draws less attention than having the charter amended and reducing the par value of the shares.

6. As shares without par value may be issued for almost a nominal consideration, there is less danger of over-capitalization when setting up intangible assets with a view to issuing shares for such assets and having such shares made available for bonus purposes.

7. When the market value of shares of very successful corporations becomes so high that they are cumbersome in trading, these may be broken up into a larger number of No Par shares to facilitate trading. This plan usually works out much better than breaking up into shares of a smaller par value.

8. They enable corporations with high earnings to break up their Par Value shares into a larger number of No Par Value shares, so that even if the dividend rate is lower than before, the actual return to shareholders is higher.

9. They should tend to a more accurate valuation for property taken in exchange for shares.

10. Since shares without par value may be issued at prices to be determined, and possibly for a small amount, this affords an opportunity for a much wider distribution of the shares through an appeal to the small investors.

11. It is possible, under many of the Companies Acts, for a corporation, through the issue of No Par shares, to build up a large paid-in surplus which may be used to absorb costs of organization and losses. This point will be referred to later when discussing disadvantages.

12. They avoid confusion, in the statement of dividend rates, that frequently arises when shares have a real value much above their par value, and the dividend rate and earning power would appear very high on the par value, while they may be very moderate when based on the real or book value.

13. Under the Canadian law, the shares of mining companies may be issued at a discount when they have a par value. The issue of shares without par value avoids the discount feature, and thus brings into the accounts only the amount that has been obtained from the issue of the shares.

Advantages from the Point of View of Investors.

1. Since the liability of shareholders is limited to the price agreed, which may be a comparatively small amount, this gives scope for broader investments when the issue price is low.

2. They make a greater appeal to the investor since, while they may be offered at attractive prices, there is no discount involved, which should give them a wider market. This is important for mining companies.

3. They are less likely to mislead the subscribers, since there is no fictitious nominal value. This should lead to investigation and a wider knowledge of corporate affairs. Attention is directed rather to the actual book value.

4. The investors are less likely to be confused by a dividend stated in dollars or cents, or both, than one expressed in percentages when the par value on which the percentage is based may have little relation to real values.

Possible Advantages to Others. It is claimed for No Par shares that, since they may be more readily issued, funds may be made available more quickly, which should be an advantage to creditors.

Possible Disadvantages. It can hardly be claimed that No Par shares possess no disadvantages. Reference has been made, under Advantages to the Corporation, to the fact that it is possible to build up a large capital surplus through the issue of No Par shares in many cases. This draws attention to a probable disadvantage, since the subscribers may believe that the full amount of their contributions is to be used as capital funds, whereas, if a part is diverted to capital surplus and this is distributed in dividends, a false impression may be easily created as to the stability and earning power of the corporation.

This disadvantage does not arise in the issue of true No Par shares, but is made possible through the departure from true No Par shares through the provisions made in Company Law. It must not be assumed then that they give complete protection against unscrupulous promotion.

The above facts may mean, also, less protection to the creditors since, if money paid in for shares can be paid out again in dividends, the creditors are not protected as they would be under Par Value shares or under true No Par shares, where the whole consideration is treated as capital.

Another possible disadvantage arises from the fact that, since No Par shares are usually issued for small amounts, there will not likely be large amounts outstanding on the shares, and thus there may be less protection for the creditors on this account.

From the point of view of shareholders there may be a disadvantage in the fact that if later issues in the same class are made at a lower figure, their equity will be reduced, since all the shares will be equal.

A disadvantage may arise if the accounting features are not carried out in a way to show the exact nature of the shareholders' equity.

In connection with the above, it is important that the capital and surplus be properly set up in the Balance Sheet, or the information as to the protection of creditors may be made misleading.

The points referred to above should be sufficient to bring out the general idea behind the desire for authority to issue No Par shares. The discussion of this phase could be broadened still further, but that would be more appropriate in a study from the point of view of Corporation Finance rather than of Accounting.

Accounting for the Issue of No Par Shares

Account must be in Accord with Legal Provisions. The provisions under different Companies Acts draw attention to the fact that different methods may be applied in recording the issue of shares without par value. Accounts must be kept in accord with the law under which the company is

formed, and it should not be assumed that any or all of the methods that will be referred to may be adopted by every company. In the organization of a company with No Par shares, and in making the accounting records, a study of the charter and the provisions of the particular Act governing the company's operations should be made.

As Company Law is frequently changed, it is hardly desirable that sections be quoted as from certain Acts, and thus perhaps give the impression that these provisions hold after the Act may have been amended in this particular. Quotations from different Acts may be given as at the time of writing, however, to bring out the difference in the provisions that may be applied, and thus the different accounting methods that may be employed.

It is invariably provided that, within a class, each share without par value is equal to each of the other shares, even though they may not have been issued at the same price.

Method 1. A certain Act permits the issue of shares without any nominal or par value except in the case of Preferred Stock having a preference as to Principal. It then goes on to provide—

"The amount of capital with which the company shall carry on business shall not be less than the aggregate amount of the consideration for the issue and allotment of the shares without nominal or par value from time to time outstanding, and in addition thereto an amount equal to the total par value of all other issued and outstanding shares of the capital stock of the company."

In the above, the important point to observe is that the whole of the consideration received from the issue of shares without par value must be included and set up as part of the capital of the company. This illustrates the idea of TRUE NO PAR SHARES, and, if adhered to, would avoid much of the confusion that may arise under other provisions.

In this case, when the Preferred shares are issued, the amount of their preference and all other details regarding them must be clearly stated. In the example that follows it is assumed that the Preferred are preferred as to assets to their par value, and that they are restricted to that amount.

Problem. The M Company, Ltd., with an authorized capital of $1,000,000.00 in 7 per cent. Cumulative Preferred shares of $100.00 each, and 10,000 Common shares without par value, has issued and received payment for 5,000 shares of Preferred at par, 5,000 shares Common at $10.00 a share, and 3,000 shares Common at $12.00 a share. At December 31, 19—, it has accumulated a surplus of $110,000.00, of which $100,000.00 is recorded at the credit of Reserve Fund, and $10,000.00 as Unappropriated Profits.

(*a*) Set up, in condensed form, the Balance Sheet at that date.

(*b*) There are no arrears of preferred dividends. If, in a certain year, the amount to be appropriated for dividends is $59,000.00, what dividends are declared?

Solution. (*a*) It is obvious that if the company were wound up at this time, $500,000.00 of the value of the assets must be applied to paying off the Preferred shares. If this is the limit fixed, and creditors are provided for, the balance of the assets would represent the equity of the common shareholders. Under these conditions the Balance Sheet may be set up as follows (assuming there are Sundry Liabilities of $100,000.00)—

THE M COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry			$796,000.00
			$796,000.00

Liabilities and Capital

Liabilities			
Creditors			$100,000.00
Shareholders' Equity			
Capital Stock Subscribed and Paid—			
Preferred		$500,000.00	
Common—Authorized 10,000 shares without par value Issued—8,000 shares	$86,000.00		
Reserve Fund	100,000.00		
Unappropriated Profits	10,000.00	196,000.00	696,000.00
			$796,000.00

This shows a value behind 8,000 Common shares of $196,000.00, or $24.50 a share.

Capital *v.* Surplus. Care must be taken to show just how this amount is made up. It would not be correct to show it in one amount without the division. If presented to a bank in that form it would give the impression that the whole amount belonged to Capital Stock, whereas $110,000.00 of this is available for distribution. It would prejudice the company's position with creditors also, and create a false sense of security, since the surplus would not be apparent and may be paid out later in dividends.

Stated or Legal Capital is the amount below which the net assets of the company may not be reduced through payment of dividends (except in the case of mining companies).

In this example, the stated or legal capital, which must appear in the Capital Stock Accounts, is the amount from Preferred shares, $500,000.00,

plus the whole consideration received for shares without par value, $86,000.00 This would appear to illustrate the original idea when No Par shares were introduced. That is, the whole consideration received is set up as capital and this amount must be kept intact, except in so far as it may be reduced by losses.

Dividends—How Expressed. (*b*) The point illustrated here is the manner of expressing dividends on No Par shares. The Preferred dividends will require $35,000.00, so it is apparent that $24,000.00 is being appropriated to Common. This, on 8,000 shares, would provide a dividend of $3.00 a share. It will be observed first that the rate cannot be expressed as a percentage, for there is no face value on which to base it, but it is expressed as so many dollars or cents a share. It will be observed next that, although these shares have not all been issued at the same amount, the dividend, as they are all within the one class, will be the same on each.

Method 2. Another Act states provisions that may be taken as a basis to illustrate a variation from that brought out in the first method.

"1. Any or all of the shares of any company may be issued without any nominal or par value, provided there be included in its letters patent the following statements—

(*a*) The total number of shares that may be issued by the company;

(*b*) The number of shares, if any, which are to have a par value and the par value of each;

(*c*) The number of shares which are to be without par value; and

(*d*) Either one of the following clauses—

(i) The capital of the company shall be at least equal to the sum of the aggregate par value of all issued shares having par value, plus   dollars (*the blank space being filled in with some number representing one dollar or more*) in respect to every issued share without par value, plus such amounts as, from time to time, by by-law of the company, may be transferred thereto; or

(ii) The capital of the company shall be at least equal to the sum of the aggregate par value of all issued shares having par value, plus the aggregate amount of consideration received by the company for the issuance of shares without par value, plus such amounts as, from time to time, by by-law of the company, may be transferred thereto.

"2. There may also be included in such letters patent an additional statement that the capital shall not be less than   dollars (*the blank space being filled in with a number*). Such statements in the letters patent shall be in lieu of any statements prescribed by this Act as to the amount of its

capital stock, or the number of shares into which the same shall be divided, or of which it shall consist.

"3. Subject to the designations, preferences, privileges and voting powers or restrictions or qualifications granted or imposed in respect to any class of shares, each share with or without par value shall be equal to every other share of the same class."

At least two ways of setting up Capital Stock are referred to here, with the possibility of a third. The second is similar to that already illustrated, with the provision added covering transfers from Surplus to Capital Stock.

The first provides for a possible division in the amount received on account of No Par shares. The charter may state that a certain amount, representing $1.00 or more, may be treated as capital, so that if the amount stated is $1.00, and the shares are issued at $15.00, a strict adherence to this provision would allow $14.00 a share to be set up in an account separate from Capital Stock. The stated capital, as far as these shares are concerned, must be at least $1.00 a share, and the stated or legal capital is the amount that will be carried to the credit of Capital Stock.

It has been pointed out that true No Par shares could not be issued at a premium, as there is nothing on which to base it. In this case, the excess over the amount to be credited to Capital Stock will not be termed premium on shares. Its relation, however, is very similar and it represents Paid-in Capital Surplus.

For illustration it will be assumed that there are Preferred shares issued with a par value, although the sections quoted would allow all shares to be without par value, if desired.

Problem. The N Company, Ltd., with an authorized capital of $1,500,000.00 of 7 per cent. Cumulative Preferred in shares of $100.00 each, and 20,000 shares of Common, without par value, has $1,000,000.00 of Preferred issued and paid up. Of the Common shares, 14,000 were issued at $10.00 a share, and 3,000 at $11.00 a share. The charter provides that $4.00 received on each share of Common is to be treated as capital. Prepare a condensed Balance Sheet, assuming that there is a surplus from earnings of $320,000.00 of which $300,000.00 is shown as Reserve Fund. (Creditors, $150,000.00.)

Solution.

THE N COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry	$1,643,000.00
	$1,643,000.00

Continued on next page

Liabilities and Capital

Creditors		$150,000.00
Shareholders' Equity		
Capital Stock—		
7% Preferred—Subscribed and Paid		1,000,000.00
Common—represented by 17,000 shares without par value, Subscribed and Paid, out of 20,000 shares authorized to be issued	$68,000.00	
Paid in Capital Surplus	105,000.00	
Reserve Fund	300,000.00	
Unappropriated Profits	20,000.00	493,000.00
		$1,643,000.00

The Legal or Stated Capital in this Balance Sheet is $1,000,000.00 Preferred and $68,000.00 Common. The surplus from earnings is, of course, available for distribution. The relation of the Paid-in Surplus differs from the Earned Surplus in the sense that it is a Capital Surplus only. As pointed out, it is not a premium on shares, but, in its treatment, it will stand in a very similar relation. It may be applied to writing off capital expense charges, or capital assets of an intangible nature, or losses arising from causes outside of operation, or even deficits from operation. Like Premium on Shares, there would appear to be nothing in law to prevent its distribution in dividends, so that a situation might easily arise under these conditions where shareholders, having paid a certain amount for their shares, receive dividends almost immediately, appropriated out of the amounts they had paid in for the shares on which the dividends are paid. This point will come up a little later in referring to another provision.

Transfers from Surplus to Capital. The example dealt with comes under the reference to provisions where, in addition to stated capital being shown either at the total consideration received or for a stated amount of the consideration received, capital may include such amounts as are transferred thereto. If $100,000.00, for instance, of the amount shown in Reserve Fund were transferred to Capital Stock, the stated or legal capital represented by Common shares would be $168,000.00. Assuming that it is found that there is no particular need for the Paid-in Surplus of $80,000.00, and this were also transferred to Capital, the stated or legal capital represented by Common shares would be $248,000.00, the surplus in each case being reduced accordingly, although the equity of the common shareholders is not changed. These transfers would irrevocably capitalize these amounts taken from surplus, i.e. they could not be brought back to surplus. Such a step then would be taken only when it is reasonably sure that the surplus is not required for anything else, and when it is desired to protect the amounts against demand for distribution.

Authorized Shares in Balance Sheet. It is considered desirable, in setting up No Par shares in the Balance Sheet, to show the number authorized, less the number unissued. This may be done quite easily, and may

be important since the equity behind each share may be affected by the amount at which further shares are issued.

PREFERENCE MUST BE STATED. Since, under the provision quoted, any or all of the shares may be without par value, and as it is inferred in the last part of the quotation that No Par shares may be of different classes, there would appear to be nothing to prevent both Preferred and Common shares being issued with a provision that only a part of the consideration received is to be set up as legal or stated capital, and so the paid-in capital surplus may come from both sources. In winding up, however, the Preferred would have a preference for the amount provided as a preference as to assets, which should amount to at least the figure at which it was issued.

A case in point will illustrate the effect of this.

A large corporation issued all shares without par value. The Preferred were preferred as to dividends to the amount of $7.00 a share, and were issued at $100.00 a share, with provision in the charter that one dollar of the consideration received for each share was to be set up as capital. Common were issued largely for intangible assets. A very large paid-in capital surplus, built up on the issue of Preferred, was applied to write off intangible assets for which the Common had been issued and a large balance remained. As a result, shares that were set up in the Capital Stock Account at $1.00 each were receiving $7.00 a year dividends, but it will be remembered that they had been issued at $100.00 each.

This brings out the fact that these provisions may easily cause balance sheets to be produced which, while they may show the financial position of the company at the moment, would make obscure some of the facts relative to the issue of shares.

To show the equity of the Common shares in that case, the amount of Preference in the distribution of assets to the Preferred, over and above the amount at which it has been set up in the Capital Stock Account, would have to be taken into consideration.

Problem. The C Company, Ltd., has an authorized capital of 10,000 shares Preferred and 5,000 shares Common, all without par value. The Preferred is preferred as to assets to the amount of $50.00 a share, and restricted to that amount after dividends of $3.00 a share, cumulative, are covered. Of the Preferred, $30.00 a share is to be treated as capital, and of the Common, $1.00 a share. Eight thousand shares of Preferred are issued at $50.00, and 3,000 shares Common at $10.00 a share. After two years' operations, the company has accumulated profits of $110,000.00, recorded as $90,000.00 in Reserve Fund, and $20,000.00 in Unappropriated Profits. Creditors Accounts are $20,000.00.

(*a*) Raise entries to open the books of the company.

(*b*) Prepare condensed Balance Sheet as at the end of two years. The capital surplus has not been disturbed.

(*c*) Assuming that in the first year there was a loss of $10,000.00, but the dividends on Preferred stock were paid, prepare a condensed Balance Sheet. Creditors, $15,000.00.

Solution. (*a*) Entries in journal form.

Subscribers—Preferred	$400,000.00	
To Capital Stock—Preferred		$240,000.00
,, Paid in Capital Surplus		160,000.00
To record issue of 8,000 shares, Preferred, at $50.00 a share, of which $30.00 a share is to be treated as capital.		
Cash	400,000.00	
To Subscribers—Preferred		400,000.00
Subscribers—Common	30,000.00	
To Capital Stock—Common		3,000.00
,, Paid in Capital Surplus		27,000.00
To record issue of 3,000 Common shares at $10.00, of which $1.00 is to be treated as capital.		
Cash	30,000.00	
To Subscribers—Common		30,000.00

(*b*) THE C COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry			$560,000.00
			$560,000.00

Liabilities and Capital

Liabilities			
Creditors			$20,000.00
Shareholders' Equity			
Preferred Capital Stock—			
Authorized—10,000 shares without par value—preferred to $50 a share—			
Issued—8,000 shares	$240,000.00		
Portion of Capital Surplus	160,000.00	$400,000.00	
Common Capital Stock—			
Authorized—5,000 shares without par value—			
Issued—3,000 shares	3,000.00		
Paid-in Capital Surplus	27,000.00		
Reserve Fund	90,000.00		
Unappropriated Profits	20,000.00	140,000.00	540,000.00
			$560,000.00

(c) THE C COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets		
Sundry		$411,000.00
		$411,000.00
Liabilities and Capital		
Liabilities		
Creditors		$15,000.00
Shareholders' Equity		
Preferred Capital Stock—		
Authorized—10,000 shares, no par value—		
Issued—8,000 shares	$240,000.00	
Common Capital Stock—		
Authorized—5,000 shares—no par value—		
Issued—3,000 shares	3,000.00	
Paid-in Capital Surplus	153,000.00	396,000.00
		$411,000.00

NOTE. The Preferred shares are preferred as to assets to the amount of $50.00 a share, or $400,000.00.

Entries transferring loss and appropriations—

Profit and Loss Appropriation	$10,000.00	
To Profit and Loss		$10,000.00
To close the current Profit and Loss Account.		
Paid in Capital Surplus	34,000.00	
To Profit and Loss Appropriation		34,000.00
To transfer from surplus the amount required to cover loss and dividend.		
Profit and Loss Appropriation	24,000.00	
To Dividend—Preferred		24,000.00
Dividend of $3.00 a share on 8,000 shares.		

BALANCE SHEET VARIATIONS. The difference in the form of the Balance Sheets (*b*) and (*c*) is not due entirely to the difference in conditions. Very often the form used in (*c*) would be used instead of that in (*b*), but this would lack the clear distinction between the equity of the Preferred and that of the Common, which it is desirable to bring out.

If nothing is brought into the Preferred section to show the total amount of the equity, the capital surplus would be entirely in the group following, without distinction as between Preferred and Common. A note should then be added to the Balance Sheet, if the statement is not made within it, to

the effect that the Preferred is preferred as to assets to the amount of \$50.00 a share.

A disadvantage of that method is that a calculation is necessary to find the equities of each class of shareholders.

In (*c*) the position is that there is not an amount of net assets equal to the amount for which the Preferred shares will be preferred in winding up. There is, therefore, no equity behind the Common. The Balance Sheet cannot be set up as it is in (*b*) for these reasons.

LACK OF PROTECTION TO PREFERRED. This brings out the further peculiar fact that it is possible (unless there are other restrictions), when shares are issued in the above manner, to reduce the net value of the assets below the amount to which the Preferred shares would be preferred as to assets in winding up and yet be within legal limits, since the amount of the Preferred shares that is to be treated as capital has been set up, and the assets are not reduced through dividends below the amount treated as capital for both Preferred and Common shares.

PROTECTION. It should be remembered that under the second form referred to in the quotation from the Statutes, this condition could not arise, since the full amount received for Preferred must be set up as capital.

Another Act provides that the capital with which the company will carry on business, which amount shall be not less than the amount of Preferred stock, if any, authorized to be issued with a preference as to principal, and in addition thereto a sum equivalent to five dollars or to some multiple of five dollars for every share authorized to be issued other than such Preferred stock, etc.

In this case, the only difference is that the amount credited to Capital Stock Common, when the shares have no par value, must be five dollars or a multiple thereof for each share. This seems to leave the way open for a division along the lines already illustrated, except for this difference in amount.

Method 3. A quotation from the provisions of another statute, while bearing out largely the same ideas as already illustrated, makes more definite some of the points involved. After stating the authority for the issue of shares without par value and providing definitely that Preference shares may be in this form, provisions continue as follows—

"In the absence of other provisions in that behalf in the latters patent, supplementary letters patent or by-laws of the company, the issue and allotment of shares without nominal or par value authorized by this section may be made from time to time for such consideration as may be fixed by the board of directors of the company; and in fixing the amount of such consideration, except in respect of shares without nominal or par value having a preference as to principal, the board may provide that a part thereof may be set aside as a distributable surplus."

It will be observed that in this case Preferred shares may be issued without par value, but that if they are preferred as to principal the whole amount of the consideration received for such shares must be set up as capital, but in the case of shares that have no preference as to principal, a portion of the consideration received may be set apart as a distributable surplus. No question arises in this case as to the position of the paid-in capital surplus, since there is the definite statement that it is distributable.

Problem. The D Company, Ltd., has an authorized capital of 10,000 shares Preferred, and 5,000 shares Common, all without par value. The Preferred is preferred in dividends at $3.00 a share, cumulative, and in winding up is restricted to a preference in the distribution of assets to $50.00 a share.

Of the Preferred, 8,000 shares are issued at $50.00 and paid up, and of the Common, 3,000 shares are issued at $10.00 a share, of which it is provided $1.00 a share shall be shown as capital. A further 1,000 shares of Common were issued to cover organization expense. These are to be recorded as issued at $5.00.

Raise entries to open the accounts of the company and set up the resultant Balance Sheet.

Solution. Entries (all in journal form).

Subscribers—Preferred	$400,000.00	
To Capital Stock—Preferred		$400,000.00
Issue of 8,000 shares Preferred at $50.00.		
Cash	$400,000.00	
To Subscribers—Preferred		$400,000.00
Subscribers—Common	30,000.00	
To Capital Stock—Common		3,000.00
,, Paid in Capital Surplus		27,000.00
Issue of 3,000 shares at $10.00 of which $1.00 is set up as capital.		
Cash	30,000.00	
To Subscribers—Common		30,000.00
Subscribers—Common	5,000.00	
To Capital Stock—Common		1,000.00
,, Paid in Capital Surplus		4,000.00
Issue of 1,000 shares at $5 a share of which $1.00 is set up as capital.		
Organization Expense	5,000.00	
To Subscribers—Common		5,000.00
Paid in Capital Surplus	5,000.00	
To Organization Expense		5,000.00
To write off expense of organization.		

THE D COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Cash			$430,000.00
			$430,000.00

Shareholders' Equity

Preferred Capital Stock—no par value— Authorized—10,000 shares— Issued—8,000 shares		$400,000.00	
Common Capital Stock—no par value— Authorized—5,000 shares— Issued—4,000 shares	$4,000.00		
Paid-in Capital Surplus	26,000.00	30,000.00	$430,000.00
			$430,000.00

Other Features

Deficits in Balance Sheet.

Problem. The E Company, Ltd., has issued 5,000 shares of 7 per cent. Cumulative Preference Stock of $100.00 each, at par, and 7,000 shares of Common, without par value, at $20.00 a share. At December 31, 19—, the accounts show that there is owing to creditors $100,000.00, and there is a deficit from operations of $25,000.00. The full amount received from the issue of Common shares had been credited as capital. Prepare a Balance Sheet in condensed form.

Solution.

THE E COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry			$715,000.00
			$715,000.00

Liabilities and Capital

Liabilities			
Sundry Creditors			$100,000.00
Shareholders' Equity			
Preferred Capital Stock— Subscribed and Paid		$500,000.00	
Common Capital Stock— 7,000 shares without par value	$140,000.00		
Deduct Deficit	25,000.00		
Equity of Common Shares		115,000.00	615,000.00
			$715,000.00

When there is a deficit, the stated or legal capital cannot be reduced on the Balance Sheet without legal authority. It must then be distinctly stated. The equity of the Common shares, however, can be clearly shown only if, after showing the legal or stated capital, the deficit is deducted therefrom. The deficit is not an asset to be grouped as such, but indicates a reduction of the shareholders' equity to below the amount of legal or stated capital. It will be observed that the object is to show the equity of each class of shareholders as well as the Paid-up Capital, and this method does not show a reduction of capital, but an impairment of equity to less than Capital Stock Paid-up.

Effect if Contribution Divided. Had the Common stock been issued under a provision that $10.00 a share was to be credited as capital, the deficit of $25,000.00 would be written off by transferring that amount from Capital Surplus to the Appropriation Account. The Capital Surplus originally set up at $70,000.00 would be reduced to $45,000.00, and with the legal capital of $70,000.00 shows the same Common share equity of $115,000.00. As the Balance Sheet would then show the legal capital intact, and a capital surplus as well, although the contributed capital was the same as in the form in which the example was first given, the reason for the right to divide the amount contributed between Capital Stock and Capital Surplus is apparent.

Change from Par to No Par. The reasons for change from Par Value to No Par Value have already been referred to in the discussions of the advantages claimed for No Par stock.

One of the conditions referred to is that of the book or market value of the shares becoming so much greater than par that par value does not nearly express their real value.

Suppose that the F Company, Ltd., with Paid-up Capital Stock of $5,000,000.00, in shares of $100.00 each, has accumulated a surplus of $2,500,000.00, and has at the same time a high earning power. The shares are quoted in the market, in an active trading period, at $250.00.

The shareholders agree to a division of each share with par value into four shares without par value.

By this procedure the amount of capital stock is not changed in any way. In the Share Ledger the number of shares held by each shareholder will be different and reference to par value will disappear. A new Share Ledger would therefore be in order. As far as the financial books are concerned, there is no change. A reference should be made in the records, however, and in the Capital Stock Account, that will indicate the number of shares without par value.

Stock Dividends—No Par. Reference has already been made that, under Method 2, provision is expressed whereby the legal capital, as shown in the Capital Stock Account, may be increased by a transfer from surplus.

This may be done without any change in the number of shares, the only entry necessary being to charge Surplus and credit Capital Stock with the amount transferred. This makes such an amount no longer available for distribution.

Instead of this the directors may decide to issue a Stock Dividend.

Problem. The G Company, Ltd., has issued 10,000 shares without par value, and the amount standing at the credit of Capital Stock Account is $600,000.00. There is also at the credit of Reserve Fund Account, $300,000.00, and Unappropriated Profits, $100,000.00.

The directors declare a Stock Dividend of one share for each four shares held, and provide that $150,000.00 should be transferred from Reserve Fund to the Appropriation Account with this in view. The value placed on the new shares is $80.00 per share.

Solution. The entries are—

Reserve Fund	$150,000.00	
To Profit and Loss Appropriation		$150,000.00
Subscribers	200,000.00	
To Capital Stock		200,000.00
To record the issue of 2,500 shares at $80.00 each.		
Profit and Loss Appropriation	200,000.00	
To Stock Dividend		200,000.00
Declaration of dividend payable in shares, 1 share for each 4 now held.		
Stock Dividend	200,000.00	
To Subscribers		200,000.00

It is apparent that the equity of the shareholders has not been changed in any way, but the $200,000.00 has been irrevocably capitalized and is now a part of the legal capital, Surplus being reduced by the same amount. There will now be a balance of $50,000.00 in the Appropriation Account.

No Disadvantage to Shareholders. The number of shares representing the equity has, however, been increased, and, while the shares previously had a book value of $100.00 each, the book value is now $80.00 each. At first glance this would appear to be a disadvantage to the shareholders, but it will be remembered that each shareholder now has his holdings increased. If A held 20 shares with a book value of $2,000.00 before the dividend, he now holds 25 shares with book value of $2,000.00. If the same rate of dividend is maintained, the shareholders will receive 25 per cent. more in dividend than they did previously.

The price at which No Par shares shall be issued, in case of a stock dividend, would be determined by the directors. A fair market value is quite usually taken. The value taken in the above problem would also seem to be equitable.

Shares Issued for Assets Other Than Cash.

Problem. The F Company, Ltd., purchased assets of a going concern recorded in the vendor's books as follows: Land, $20,000.00, Buildings, $60,000.00, less Reserve for Depreciation, $12,000.00; Plant and Machinery, $80,000.00, less Reserve for Depreciation, $24,000.00; Office Furniture and Equipment, $4,000.00; Stock in Trade, $40,000.00. These were acquired at their book values, and 4,200 shares of the purchasing company, without par value, were issued in settlement.

(*a*) Raise entries to record the purchase, assuming that the whole amount of consideration received is to be treated as capital.

(*b*) Raise the entries to record the purchase, assuming that $25.00 a share is to be treated as capital.

Solution. (*a*) Journal entries—

Subscribers	$168,000.00	
To Capital Stock		$168,000.00
To record issue of 4,200 shares without par value.		
Land	20,000.00	
Buildings	48,000.00	
Plant and Machinery	56,000.00	
Office Furniture and Equipment	4,000.00	
Stock-in-Trade	40,000.00	
To Subscribers		168,000.00
To record assets acquired to cover subscriptions.		
(*b*) Subscribers	168,000.00	
To Capital Stock		105,000.00
,, Paid in Capital Surplus		63,000.00
To record issue of 4,200 shares without par value, with $25.00 a share treated as capital.		
Land	$20,000.00	
Buildings	48,000.00	
Plant and Machinery	56,000.00	
Office Furniture and Equipment	4,000.00	
Stock-in-Trade	40,000.00	
To Subscribers		$168,000.00
To record assets acquired to cover subscriptions.		

The Buildings and Plant and Machinery are recorded at net book value. The purchasing company acquires them at these amounts, and is concerned only with depreciation on these cost values in later years. From its point of view, depreciation commences only after these assets are acquired, and it will be calculated on the cost to the purchasers.

In (*b*) there is a Capital Surplus recorded of $63,000.00, and the treatment of such an item has been referred to already. As the consideration for the shares was not cash, it is suggested that the amount should not be considered as available for distribution, whatever the legal position may be.

Possible Complication. There is room for some complication in such a case as, if funds derived from other sources are applied to pay dividends appropriated from such a capital surplus, it would mean that a capital surplus may be created from consideration either tangible or intangible, and funds not related to the capital surplus be used to reduce it.

Again, if Preferred shares were issued for cash, under a provision that the whole of the consideration received for them must be treated as capital, and at the same time Common shares were issued for other assets, possibly intangible, under a provision that part of such consideration may be treated as distributable surplus, funds actually derived from the issue of Preferred shares might possibly be used to pay dividends appropriated from Capital Surplus created through the issue of Common. The assets of a business are not segregated as belonging to one or the other of different classes of shares. Such a condition as outlined should be guarded against, as it may defeat the apparent purpose of the Statute.

Accounting v. Corporation Finance. From an accounting point of view the application of this Capital Surplus to wipe out an intangible asset, or to write off organization expense, commission on shares, or deficits from operation would appear to be in order, and there would appear also to be nothing in the law, as stated, that would interfere with this. In that case there is no payment of funds derived from other sources, but merely a wiping out of one capital item by the application of a Capital Surplus legally created.

From the point of view of Corporation Finance, it will be apparent that the division of No Par shares between Stated Capital and Capital Surplus, unless ample protection is given in the law, may easily lead to conditions that may not be considered as sound, and opens the way to the creation of conditions that may easily mislead shareholders as to the application of funds contributed by them, and the capacity of the company to pay dividends from earnings, since they may be appropriated out of Capital Surplus, created from contributions made by shareholders.

CHAPTER EIGHT

CONVERSION

Conversion of Preferred Shares into Common. Shares of one class are frequently issued with the provision attached that they may be converted into shares of another class. Thus, Preferred shares may be issued convertible into Common on stated terms. If the conversion is at par, it is merely a transfer from Capital Stock Preferred to Capital Stock Common in the financial books, although to record it as a direct transfer will lose sight of the fact that there are subscribers to the new shares and that the old shares are cancelled.

Problem. The R Company, Ltd., issued $500,000.00 of 7 per cent. Preferred Stock in shares of $100.00 each. These are convertible into Common shares, at the option of the holder, on stated terms.

Raise the entries involved for the conversion of Preferred shares into Common, on July 1, 19—, assuming—

(*a*) That $100,000.00 of the Preferred shares are converted into Common at par.

(*b*) That $100,000.00 of the Preferred shares are converted at 110 into Common at par.

(*c*) That $110,000.00 of the Preferred shares are converted at par into Common at 110.

(*d*) That $100,000.00 of the Preferred shares are converted each into four shares of Common without par value.

Solution. (*a*) Holders of $100,000.00 in Preferred shares will hand in their shares and receive instead $100,000.00 in Common shares. The entries may be made as follows—

19—			
July 1	Subscribers—Common	$100,000.00	
	To Capital Stock—Common		$100,000.00
	Capital Stock—Preferred	100,000.00	
	To Subscribers—Common		100,000.00
	Holders of $100,000.00 of Preferred Stock surrender their shares and accept Common shares at par for the same amount.		

The effect of this conversion is to increase the Common stock issued by $100,000.00, and decrease the Preferred stock issued by the same amount.

(*b*) In this case the holders of $100,000.00 of Preferred stock are to receive 10 per cent. more than the face amount of their holdings, or $110,000.00 in Common stock.

Conversion Reserve. To take care of the premium of $10.00 a share, a Reserve for Premium on Conversion should have been set up, by an annual appropriation from net profits, to provide sufficient by the time the conversion takes place.

Entries—

19—			
July 1	Subscribers—Common	$110,000.00	
	To Capital Stock—Common		$110,000.00
	Capital Stock—Preferred	100,000.00	
	Reserve for Conversion Premium	10,000.00	
	To Subscribers—Common		110,000.00

If no reserve had been set up, the amount would be covered in total ($10,000.00) by an appropriation.

(*c*) Here $110,000.00 in Preferred shares are to be converted into $100,000.00 in Common shares. The Common shares are being issued at a premium.

Entries—

19—			
July 1	Subscribers—Common	$110,000.00	
	To Capital Stock—Common		$100,000.00
	,, Premium on Shares		10,000.00
	Capital Stock—Preferred	110,000.00	
	To Subscribers—Common		110,000.00

(*d*) Assuming that the whole amount for which the Common stock is issued is to be set up as capital, the entries may be—

19—			
July 1	Subscribers—Common	$100,000.00	
	To Capital Stock—Common		$100,000.00
	Issue of 4,000 shares Common stock, without par value, at $25.00 a share.		
	Capital Stock—Preferred	100,000.00	
	To Subscribers—Common		100,000.00

Conversion of Bonds into Shares. Some issues of bonds carry the privilege of conversion into shares, on certain terms. This provision will appeal to investors when the company shows a high earning power, although, if the conversion is made, they are changing from a senior to a junior security, and from the position of creditors to that of shareholders.

Problem. The M Company, Ltd., on January 1, 19—, issued $400,000.00 of twenty-year 5 per cent. bonds at par. These bonds carry a provision that after five years they may be converted, at par, into 7 per cent. Preferred shares, or at 105 into Common shares. The shares in each case to be at par.

At the end of five years the holders of $200,000.00 of the bonds handed them in for conversion—$100,000.00 into 7 per cent. Preferred shares and $100,000.00 into Common shares.

Solution. The entries in the financial books for the conversion are—

Subscribers—Preferred	$100,000.00	
To Capital Stock—Preferred		$100,000.00
Issue of $100,000.00 of Preferred shares at par.		
Bonds Payable	100,000.00	
To Subscribers—Preferred		100,000.00
Conversion of $100,000.00 of bonds at par into Preferred shares.		
Subscribers—Common	105,000.00	
To Capital Stock—Common		105,000.00
Issue of $100,000.00 Common shares at ~~par.~~ 105		
O.K		
Bonds Payable	100,000.00	
Premium on Bonds Converted	5,000.00	
To Subscribers—Common		105,000.00

While this disposes of the conversion as far as the bonds and the shares are concerned, there remains to be dealt with the premium on bonds converted.

If all the bonds had been converted into Common shares, this premium would have amounted to $20,000.00, and preparation should have been made for it during the five years. This may have been done by the entry each year—

Profit and Loss Appropriation	$4,000.00	
To Bond Conversion Reserve		$4,000.00

There would thus be at the credit of the Conversion Reserve $20,000.00.

As $5,000.00 Premium has been allowed, this will now be written off by the entry—

Bond Conversion Reserve	$5,000.00	
To Premium on Bonds Converted		$5,000.00

Instead of opening up the new account for the Premium, the charge could have been made direct to the Conversion Reserve.

If the Conversion Reserve had not been set up, it would be necessary to write off the Premium on Bonds Converted by an appropriation out of net profits. It is very desirable, however, that the provision be made before the conversion.

Problem. Following is the Balance Sheet (condensed) of The S. Company, Ltd., as at December 31, 19—.

THE S COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets		
Sundry		$750,000.00
Deferred Charges—		
Discount on Bonds		7,500.00
		$757,500.00
Liabilities and Capital		
Sundry Creditors		$50,000.00
Bonds Payable		200,000.00
Capital Stock—		
Subscribed and Paid	$350,000.00	
Reserve Fund	130,000.00	
Bond Conversion Reserve	27,500.00	507,500.00
		$757,500.00

The bonds were issued five years ago at 95, for a period of 20 years, and are convertible at this date at 110 into shares at par.

One hundred thousand dollars, par value, of bonds are handed in for conversion. Raise the necessary entries.

Solution.

Subscribers	$110,000.00	
To Capital Stock		$110,000.00
Issue of 1,100 shares at par for immediate settlement.		

Continued on next page

Bonds Payable	100,000.00	
Bond Conversion Reserve	10,000.00	
To Subscribers		110,000.00
Settlement by subscribers through conversion of bonds at 110.		
Bond Conversion Reserve	3,750.00	
To Discount on Bonds		3,750.00
To write off one-half the discount on account of bonds converted into shares.		

The bond discount was originally \$10,000.00, of which one-quarter has been written off by charging to Profit and Loss, $\$\frac{10{,}000.00}{20} = \$500.00$ each year, leaving \$7,500.00.

The Conversion Reserve has been set up by annual appropriation of \$5,500.00, and the amount is just sufficient to cover 10 per cent. premium on all the bonds, had all been converted, and also to cover the discount on bonds in full. As only one-half of the bonds have been converted, the balance of the reserve may be left pending further conversions.

One-half the remaining discount has been written off, and the balance is the proportionate amount that applies to the bonds still outstanding.

THE S COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry		\$750,000.00
Deferred Charges—		
Discount on Bonds		3,750.00
		\$753,750.00

Liabilities and Capital

Sundry Creditors		\$50,000.00
Bonds Payable		100,000.00
Capital Stock—		
Subscribed and Paid	\$460,000.00	
Reserve Fund	130,000.00	
Bond Conversion Reserve	13,750.00	603,750.00
		\$753,750.00

It is desirable that conversions should be at the option of the holder of shares or bonds, and in the examples given this is assumed.

Conversion of Shares into Stock. Some of the Company Acts provide that a company may change its capital from Shares to Stock and, later, from Stock back to Shares. While the accounting is extremely simple for such a change, the nature of the change itself may not be so well understood.

Difference Between Shares and Stock. When the capital is divided into shares it may be compared to a number of small parcels, each of which is, of course, distinct from the others. When a transfer of shares is made, it will be in denominations of the shares. Thus, $100.00 shares are transferred in denominations of $100.00.

If the Paid-up Capital of a company is $500,000.00, in shares of $100.00 each, there will be 5,000 of these small parcels. Suppose, however, that it is desired to change from Shares into Stock. Cut the bands around these parcels and let the whole structure fall into one mass, without any division. Now it is Stock. If a person held one share of $100.00, fully paid up, he would now hold $100.00 of Stock, but, while previously he would transfer in denominations of $100.00, he may now transfer his holdings in any amount at all, subject only to whatever provisions are made as to round amounts, possibly $5.00 or multiples thereof.

Stock must be fully paid. It is possible to have shares issued that are partly paid only.

Effect of Conversion. It will be observed that if the change is made at the par amount of the paid-up shares there is no difference at all in the Paid-up Capital Stock, and, as long as shares do not appear in the title, it may not even be necessary to change the account, but some indication in the account is desirable. The main difference is in the amounts at which transfers may be made.

Methods and Accounting Features. If the shares are converted into stock for an amount less than the Paid-up Capital, the stock will be recorded as issued at a premium.

Problem. The A Company, Ltd., with Paid-up Capital of $200,000.00, represented by 2,000 shares of $100.00 each, decided to convert the shares into Stock.

(*a*) Raise entries assuming that the conversion is at par.

(*b*) Raise entries assuming that the amount of stock issued for the shares is $175,000.00.

(*c*) Raise entries assuming that the stock issued is $220,000.00.

Solution. To keep the distinction clear, the Capital Stock now represented by shares will be referred to as Share Capital in the entries.

(*a*) Share Capital	$200,000.00	
To Stock		$200,000.00
For conversion of 2,000 shares ($100.00 each fully paid up) into Stock at par. (Quote authority.)		

(*b*) Share Capital	$200,000.00	
To Stock		$175,000.00
,, Premium on Stock		25,000.00
Conversion of the company's share capital $200,000.00 into Stock at the rate of 87½ per cent. of Stock for the amount of Share Capital issued and paid. (Quote authority for this action.)		

The above entries remove the Share Capital entirely from the books and substitute the account for Stock.

(*c*) Share Capital	$200,000.00	
Share Conversion Reserve	20,000.00	
To Stock		$220,000.00
Conversion of 2,000 shares of $100.00 each, fully paid up, into Stock at the rate of $110.00 of stock for each $100.00 share.		

It is assumed that the Conversion Reserve has been built up out of Surplus to prepare for this conversion. If not, a transfer from Surplus would be necessary to write off the charge.

In (*c*) the holdings represented by Stock will be greater than their former holdings as Shares by 10 per cent.

It is very seldom that these accounting features arise in Canada, but, as they are provided for in some of the Acts, it is desirable that the accounting features be understood, as well as the general meaning of the conversion.

The share certificates will be handed in and certificates for Stock, without any reference to shares at all, issued instead. If a person held Stock to the amount of $2,000.00 and desired to transfer $575.00 of this, a new certificate would be issued to the purchaser for $575.00 of Stock, and the former holder would receive a new certificate for $1,425.00 Stock. He would, of course, first surrender his original certificate for $2,000.00 of Stock.

CHAPTER NINE

INCREASE OR DECREASE OF CAPITAL STOCK

Increase of Capital Stock

No entries are necessary in the accounts for an increase of authorized capital, except when a special account is kept for Unsubscribed Stock, in which case this account would be debited and Capital Stock credited for the amount of the increase. Whenever new stock is issued, however, entries must be made dealing with the new subscriptions in the same manner as with the original subscriptions.

Decrease of Capital Stock

Procedure—Purposes. A reduction in capital stock may be made only after legal requirements have been complied with and Supplementary Letters obtained. Reductions are generally for one of three purposes—

(*a*) To extinguish or reduce the liability on any of its shares in respect of share capital not paid up;

(*b*) Either with or without extinguishing or reducing liability on any of its shares, to cancel any paid-up share capital which is lost or unrepresented by available assets; or

(*c*) Either with or without extinguishing or reducing liability on any of its shares, to pay off any paid-up share capital which is in excess of the wants of the company.

If the reduction extinguishes the liability of subscribers on shares not fully paid up, the interests of creditors may be prejudiced, since with the subscribers' liability removed, the amounts could not be called up to provide funds to pay creditors.

If the reduction involves a repayment to shareholders of paid-up capital, funds would be taken out of the business and the position of creditors again may be prejudiced. If the reduction is in either of these two forms, provision is made in the law for the protection of creditors before the reduction would be permitted.

The accounting features under each of the three methods referred to will be taken up in order.

(*a*) Reducing the Liability on Unpaid Shares.

Problem. The A Company, Ltd., with an authorized capital of $1,000,000.00 in shares of $100.00 each, has issued 6,000 shares at par, on which 60 per cent. is called up and paid.

The company, finding it is not likely to require the full amount unpaid on the shares issued, obtained permission to reduce its authorized capital to $750,000.00, by reducing the par value of the shares from $100.00 to $75.00, and so reducing the uncalled amounts from $40.00 to $15.00 a share.

Solution. Assuming that Authorized Capital is recorded in the accounts, there will be a debit of $400,000.00 in Unsubscribed Capital Account, and $240,000.00 in Subscription Account.

Adjustment entry—

Capital Stock—Authorized	$250,000.00	
To Unsubscribed Capital		$100,000.00
,, Subscription		150,000.00

If Subscribed Capital is recorded in the accounts there will be the same debit of $240,000.00 in Subscription Account.

Entry to adjust—

Capital Stock—Subscribed	$150,000.00	
To Subscription		$150,000.00

In either of the above cases the amount shown in Subscription Account, that may be called, is $15.00 a share, or $90,000.00.

Should Paid-up Capital only be recorded, no entry is necessary, as a charge will be made to Subscribers only as calls are made. The limit that may be called is $15.00 a share.

(*b*) Reducing Paid-up Share Capital Which is Lost or Unrepresented by Available Assets. When capital has become impaired and the Paid-up Capital is reduced to overcome the impairment, it is not unusual to obtain permission to reduce the capital by more than the impairment, to provide against further losses.

Problem. On the next page is given the Balance Sheet of The B Company, Ltd., in condensed form.

THE B COMPANY, LTD.

Balance Sheet
November 1, 19—

Assets

Sundry Assets	$420,000.00
Deficit	60,000.00
	$480,000.00

Liabilities and Capital

Creditors	$80,000.00
Capital Stock—Paid-up	400,000.00
	$480,000.00

Or

THE B COMPANY, LTD.

Balance Sheet
November 1, 19—

Assets

Sundry Assets		$420,000.00
		$420,000.00

Liabilities and Capital

Liabilities—		
Sundry Creditors		$80,000.00
Capital Stock—		
Subscribed and Paid	$400,000.00	
Deduct Deficit	60,000.00	
Shareholders' Equity		340,000.00
		$420,000.00

Note. The deficit of $60,000.00 stands as a debit in the Appropriation Account.

Permission is obtained to reduce the Paid-up Capital to $320,000.00 by reducing the par value of the shares to $80.00.

Solution. Entries (in journal form)—

19—			
Nov. 1	Capital Stock	$80,000.00	
	To Capital Reduction Reserve		$80,000.00
	Reduction of 20 per cent. in Paid-up Capital.		
	Capital Reduction Reserve	60,000.00	
	To Profit and Loss Appropriation		60,000.00
	To write off the deficit.		

These entries, when posted, will leave Paid-up Capital Stock credited with $320,000.00, and Capital Reduction Reserve with a credit balance of $20,000.00, which should place the shares of the company in a thoroughly healthy condition. The old certificates held by the shareholders should be returned to the company, and new ones for the decreased amounts issued in place thereof. In the Stock Ledger each shareholder will be charged *pro rata* with his part of the stock reduction.

The Balance Sheet now shows—

THE B COMPANY, LTD.

Balance Sheet
November 1, 19—

Assets

Sundry Assets		$420,000.00
		$420,000.00

Liabilities and Capital

Sundry Creditors		$80,000.00
Shareholders' Equity—		
Capital Stock Subscribed and Paid	$320,000.00	
Capital Reduction Reserve or Capital Surplus	20,000.00	340,000.00
		$420,000.00

An entry may be made to transfer the balance in the Reduction Reserve to Capital Surplus.

Capital Reduction Reserve	$20,000.00	
To Capital Surplus		$20,000.00

The shareholders' equity is not affected by the reduction. In other words, the shareholders do not lose anything. No assets went out of the business through the reduction, and the shareholders' equity, now represented by the reduced Paid-up Capital and Capital Surplus (Capital Reduction Reserve) is exactly the same as when it was represented by Paid-up Capital of $400,000.00 less a deficit of $60,000.00.

The corporation is in the same position as before the reduction, except that the amount of its Paid-up Capital is less, it has a capital surplus, and has no deficit. The reduction of capital is frequently referred to as a gain to the corporation, but actually there is neither gain nor loss. The assets and net worth are not changed. The loss giving rise to the reduction was sustained before the reduction took place, and that loss reduced the shareholders' equity.

The balance at the credit of Capital Reduction Reserve, or Capital Surplus, obtained in this way should not, in the immediate future, be treated as available for dividends. Had the company obtained permission to reduce capital and make payments to shareholders on account of their holdings, it has been pointed out that the position of the creditors must be made secure before permission would be given for the reduction.

Permission in this case has been given to reduce the capital but not to make payments to the shareholders, and to apply the capital surplus thus created to dividend purposes would seem to be going beyond the authority given, that is, the company would have obtained permission to reduce by one method and then, in part, would apply another method. The amount then should be carefully safeguarded, at least until the company is in a strong financial position.

(*c*) Reducing Paid-up Capital by Payment to Shareholders. In the financial books the only entry necessary is the record in the Cash Book of the payment made, which is charged to Capital Stock Account.

Problem. The C Company, Ltd., with a fully paid-up capital of $600,000.00 has obtained permission to reduce the par value of its shares from $100.00 to $75.00, and to pay to the shareholders $25.00 a share. The Balance Sheet, condensed, as at November 1, 19—, is as given—

THE C COMPANY, LTD.

Balance Sheet
November 1, 19—

Assets		
Cash		$200,000.00
Sundry Other Assets		600,000.00
		$800,000.00
Liabilities and Capital		
Sundry Creditors		$40,000.00
Shareholders' Equity—		
Capital Stock—Subscribed and Paid	$600,000.00	
Reserve Fund	140,000.00	
Unappropriated Profits	20,000.00	760,000.00
		$800,000.00

When a going concern reduces its capital by a payment to shareholders it will be because it has more capital funds than it requires. It is the case of a company in a very strong position, and not in a position as referred to in a previous example.

In the example taken to illustrate this feature it is assumed that the company has built up strong reserves out of net profits, but, instead of

depleting these reserves and thus weakening this protection against less favourable periods later on, it has decided to pay back to the shareholders a portion of their paid-up capital.

Solution. Expressed in journal form, the Cash Book entry is—

Capital Stock	$150,000.00	
To Cash (Bank)		$150,000.00

The Balance Sheet then appears as below—

THE C COMPANY, LTD.

Balance Sheet
November 1, 19—

Assets		
Cash		$50,000.00
Sundry Other Assets		600,000.00
		$650,000.00
Liabilities and Capital		
Sundry Creditors		$40,000.00
Shareholders' Equity—		
Capital Stock—Subscribed and Paid	$450,000.00	
Reserve Fund	140,000.00	
Unappropriated Profits	20,000.00	610,000.00
		$650,000.00

The shareholders will, as in other cases, hand in their certificates and receive new ones for the same number of shares, with a par value of $75.00 instead of $100.00.

In this case, the equity of the shareholders is reduced by $150,000.00, but there is no loss to them since they have received the amount. The net worth of the corporation is reduced by a like amount, but in relation to its shareholders for paid-up capital, its obligation, if it may be called such, is reduced by $150,000.00.

Reduction of Capital by Return of Accumulated Profits. Until a recent revision, the Companies Act of British Columbia contained the following provision, which is found also in the Companies Act of Great Britain—

"When a company having a share capital has accumulated a sum of undivided profits, which with the sanction of the shareholders may be distributed among the shareholders in the form of a dividend or bonus, it may by special resolution return the same or any part thereof to the shareholders in reduction of the paid-up capital of the company, the unpaid capital being thereby increased by a similar amount."

This raises a peculiar situation, in that shareholders may receive a part payment that results in a reduction of the Paid-up Capital of the company, but it should be observed that there is no cancellation through reduction in the par value of the shares, since Unpaid Capital is increased by a similar amount, and so may be called up again if required.

At first glance it would appear to be impossible to reduce capital by applying accumulated profits, since in the accounts these will all be recorded by credit balances, and one credit cannot be used to wipe out another.

Taking the same Balance Sheet for The C Company, Ltd., and assuming the same amount of reduction, the entries for the adjustments (expressed in journal form) are—

Reserve Fund	$120,000.00	
To Cash		$120,000.00
Capital Stock	120,000.00	
To Capital Reserve		120,000.00

By making the entries in this way there is an assurance, through the reduction in the General Reserve, or Reserve Fund, that this amount cannot again be appropriated for distribution. If, later on, the directors call up the Unpaid Capital of $120,000.00 with a credit to Capital Stock Account in the usual way, transfers may be made from the Capital Reserve Account to the credit of the Reserve Fund Account for the amounts thus called up and paid on the capital. If the whole of the $120,000.00 is so called up and paid in, and no changes had taken place in the meantime, the Balance Sheet would show exactly the same position as before the reduction was made. In the meantime, Capital Stock is recorded and paid up, $480,000.00, and Reserve Fund stands at $20,000.00.

This method is a greater protection to the corporation than either a reduction in the par value of the shares, after the payment, or the payment of dividends out of Reserve Fund, since in either of these cases the amount paid out could not be recovered, whereas, when the amount of Unpaid Capital is increased by the amount that is paid to the shareholders, it may be called back, if required.

Reduction by Redemption. Frequently, Preferred shares are issued subject to redemption at par or at a premium, the redemption being at the option of the company. Unless provided for in the charter, or by-laws creating the Preferred shares, shares could not be redeemed without the consent of the holders.

Problem. The T Company, Ltd., issued $500,000.00 of 7 per cent. redeemable Preferred shares ($100.00 par value). The redemption, at the option of the company, may take place after five years at 105.

When five years had expired the company redeemed $200,000.00 of the Preferred issue.

Raise entries, expressed in journal form, date January 1, 19—.

Solution. The company should, at the expiration of five years, have a Stock Redemption Reserve of $25,000.00, the amount of the premium on all redeemable shares, or, if it is known that only a part of the shares will be redeemed, then the reserve may be proportionately less.

19—			
Jan. 1	Capital Stock—Preferred	$200,000.00	
	Stock Redemption Reserve	10,000.00	
	To Cash (Bank)		$210,000.00
	To record redemption of $200,000.00 Preferred Stock at 105.		

If no Redemption Reserve had been set up, the charge of $10,000.00 might be made to an account for Premium on Shares Redeemed, and this, in turn, covered by an appropriation out of net profits.

CHAPTER TEN

DONATED SHARES—TREASURY STOCK

Treasury Stock Explained. The accepted application of the term "Treasury Stock," in Canada, is that it refers to shares which, having been issued for a consideration and fully paid, are donated by the holders to a trustee, that they may be disposed of and the funds thus obtained given to the company to provide Working Capital or Development Capital.

This condition is usually met with in connection with more or less speculative enterprises where, in the earlier stages, it may be difficult to issue shares to the public at par. It may arise also in an established concern whose shares cannot be issued at a minimum of par. In either case, the issue of shares at a discount is avoided. The practice has been followed also in the case of mining companies, where a part of the issue of shares has been made at a discount.

The practice of donating fully paid shares to provide Working Capital in mining companies was instituted before No Par shares became a factor in Corporation Finance. Since the authorization of No Par shares the problem of discount need not arise.

Transfer to Trustee. It is generally held in law that a company cannot traffic in its own shares, and so cannot acquire them by gift or purchase, although it may acquire shares by forfeiture for non-payment of calls and, if expressly authorized, may redeem and cancel certain shares. The donation of Treasury Stock is therefore made through, or to, a trustee, but for the benefit of the company treasury.

The following case of Black *v.* Carson is of interest in illustrating—

"Under an agreement of the members of a syndicate which organized the company a number of shares issued as fully paid-up in consideration of the transfer of assets to the company were transferred to the president and secretary of the company for the purpose of providing funds for the organization of the company and providing it with working capital. A portion only of the shares were sold, and the company having become prosperous and there being no immediate prospect of further capital being required, an action was brought by members of the syndicate to make the directors of the company account to them for the unsold balance. It was held that this was not a wrongful acquisition by the company of its own shares; that the syndicate had retained no individual interest in the shares; that the words 'for the purpose of providing funds' simply showed the way in which the funds were to be used, but did not put any limitation upon

the beneficial interest which was transferred; and that the directors were not bound to account for the unsold shares."

Legal authorities suggest that in carrying out an arrangement of this description it will usually be found to be convenient to cause the shares to be transferred to the transfer agent of the company as trustee. It is also suggested that adequate provision should be made for the voting of the shares and the disposition of dividends thereon, while the shares remain undisposed of, and the final distribution of any surplus of shares not required to be sold.

Problem. A owned some patents covering the manufacture of a certain article. On March 1, 19—, he sold a half interest in the patent to B, C, D, and E. These five obtained a charter for the A Company, Ltd., a company with an authorized capital of $500,000.00, and sold the patent to the company for $300,000.00, payable in shares. Each also subscribed and paid for 20 shares at par. A was allotted 50 shares for services in the promotion of the company.

To provide further capital, each shareholder donated to a trustee one-quarter of his shares received for the patent, by transferring these to the treasurer of the company to be sold.

Of the Treasury shares, 200 were sold on April 1, 19—, at $80.00 each, 400 on July 1, 19—, at $85.00 each, and 100 on December 1, 19—, at $105.00 each.

Raise entries to record the above, disregarding any other transactions.

There are two forms of solution, either one of which may be adopted.

Solution 1. Since a company is prohibited from trafficking in its own shares, the more logical solution would appear to be that in which no record is made in the company's financial books at the time of the donation, but a record made as payment is received from time to time and a credit made to "Reserve for Working Capital." Following this plan the solution will be as follows—

Dr. *Cash*

19—					
April	1	Subscribers		10,000	00
,,	1	Reserve for Working Capital		16,000	00
July	1	Reserve for Working Capital		34,000	00
Dec.	1	Reserve for Working Capital		105,000	00

$10,500

Journal Entries

19—			
Mar. 1	Subscribers	$315,000.00	
	To Capital Stock		$315,000.00
	Issue of 3,150 shares, payable in full at once.		
	Patents	300,000.00	
	To Subscribers		300,000.00
	Organization Expense	5,000.00	
	To Subscribers		5,000.00
	Issue of 50 shares to A for services.		

LEDGER

Dr. *Capital Stock* *Cr.*

						19— Mar.	1	Subscribers	J.	–	315,000 00

Subscribers

19— Mar.	1	Capital Stock	J.	–	315,000 00	19— Mar.	1	Patents	J.	–	300,000 00
						,,	1	Organization Expense	J.	–	5,000 00
						April	1	Cash	C.	1	10,000 00
					315,000 00						315,000 00

Patents

19— Mar.	1	Subscribers	J.	–	300,000 00						

Reserve for Working Capital

						19— April	1		C.	1	16,000 00
						July	1		C.	1	34,000 00
						Dec.	1		C.	1	10,500 00

THE A COMPANY, LTD.

Balance Sheet
December 1, 19—

Assets

Cash		$70,500.00
Patents		300,000.00
Organization Expense		5,000.00
		$375,500.00

Shareholders' Equity

Capital Stock—Subscribed and Paid	$315,000.00	
Reserve for Working Capital	60,500.00	$375,500.00
		$375,500.00

NOTE. There are 50 shares of Treasury Stock unsold.

Capital Surplus Created. The Reserve for Working Capital constitutes a Capital Surplus. It is not associated in any way with revenue, but it does add to the shareholders' equity, since assets have come in without any increase in the capital stock.

On the other side of the Balance Sheet is a capital expense called Organization Expense. There would seem no good reason why the latter should not be written off by a transfer from the Working Capital Reserve. If this is done the entry would be—

Reserve for Working Capital	$5,000.00	
To Organization Expense		$5,000.00

The Balance Sheet will then appear as below—

THE A COMPANY, LTD.

Balance Sheet
December 1, 19—

Assets

Cash	$70,500.00
Patents	300,000.00
	$370,500.00

Shareholders' Equity

Capital Stock—Subscribed and Paid	$315,000.00
Reserve for Working Capital	55,500.00
	$370,500.00

NOTE. There are 50 shares of Treasury Stock unsold.

EFFECTS. When a capital expense is written off by applying capital surplus, the shareholders' equity appears on paper to be reduced, but no value has been given out. The real equity is not changed. The Organization Expense would have no real value for security purposes, and would not be taken into account in reviewing the values in the first Balance Sheet.

A footnote is placed below the Balance Sheet to indicate the amount of Treasury Stock still unsold. This holds out the possibility of further working capital being obtained without the issue of further shares.

As the Treasury shares have been issued and are fully paid up, they may be disposed of by the trustee for any amount that can be realized. In this respect they differ altogether from shares that had not been previously issued.

Solution 2. This form of solution is one that has been generally adopted, although the first one, already given, is now being accepted as a logical one. The entries for this solution follow. In order that the transactions may be followed in order these are illustrated in journal form—

Mar. 1	Subscribers	$315,000.00	
	To Capital Stock		$315,000.00
	Issue of 3,150 shares.		
	Patents	300,000.00	
	Organization Expense	5,000.00	
	To Subscribers		305,000.00
	Treasury Stock	75,000.00	
	To Reserve for Working Capital		75,000.00
	Donation of 750 shares, fully paid.		
Apr. 1	Cash	10,000.00	
	To Subscribers		10,000.00
	Payment received from A, B, C, D, E.		
	Subscribers to Treasury Stock	16,000.00	
	Reserve for Working Capital	4,000.00	
	To Treasury Stock		20,000.00
	Sale of 200 Treasury Shares at $80.00.		
	Cash	16,000.00	
	To Subscribers to Treasury Stock		16,000.00

July 1	Subscribers to Treasury Stock	$34,000.00	
	Reserve for Working Capital	6,000.00	
	To Treasury Stock		$40,000.00
	Sale of 400 Treasury Shares at $85.00.		
Dec. 1	Subscribers to Treasury Shares	10,500.00	
	To Treasury Stock		10,000.00
	,, Reserve for Working Capital		500.00
	Cash	10,500.00	
	To Subscribers to Treasury Shares		10,500.00

The accounts in the Ledger, recording Treasury Stock and Reserve for Working Capital, are next shown—

Dr. *Treasury Stock* *Cr.*

Date			Fol.		Amount		Date			Fol.		Amount	
19—							19—						
Mar.	1		J.	–	75,000	00	April	1	Sundries	J.	–	20,000	00
							July	1	Do.	J.	–	40,000	00
							Dec.	1	Subscribers	J.	–	10,000	00
									Balance			5,000	00
					75,000	00						75,000	00
Dec.	1	Balance			5,000	00							

Reserve for Working Capital

Date			Fol.		Amount		Date			Fol.		Amount	
19—							19—						
April	1		J.	–	4,000	00	Mar.	1	Treasury Stock	J.	–	75,000	00
July	1		J.	–	6,000	00	Dec.	1		J.	–	500	00
Dec.	1	Balance			65,500	00							
					75,500	00						75,500	00
							Dec.	1	Balance			65,500	00

THE A COMPANY, LTD.

Balance Sheet
December 1, 19—

Assets

Cash	$70,500.00
Patents	300,000.00
Organization Expense	5,000.00
	$375,500.00

Continued on next page

Shareholders' Equity

Capital Stock—Subscribed and Paid		$315,000.00	
Reserve for Working Capital	$65,500.00		
Less : Treasury Stock unsold	5,000.00	60,500.00	$375,500.00
			$375,500.00

Working Capital Account. When Treasury Stock and Reserve for Working Capital are both recorded at the time of the donation, the Reserve for Working Capital Account shows the amount of Working Capital that may be obtained from the donation if all Treasury Stock is sold at par.

This possibility is reduced by the amount below par at which any of the shares are sold, while the possible amount to be realized is increased by the amount above par at which any of these shares are sold. The amount above par must not be confused with premium on shares, as the Treasury shares are not being issued but merely sold after having been issued. Likewise, the amount below par at which it is sold must not be confused with discount on shares.

Company's Own Shares Not Shown as Asset. In a Balance Sheet, a company will not show its own shares in the form of Treasury Stock as an asset, and to show the Reserve for Working Capital at the full amount credited, when the Treasury Stock has not all been sold, would overstate the amount of Working Capital actually realized at the time. The balance of unsold Treasury Stock is therefore deducted from the Reserve for Working Capital balance, and the amount so far realized is extended.

Another method would be to show, in the Balance Sheet, the net amount only, and add a footnote stating the amount of Treasury Stock unsold.

Writing Off Organization Expense. If the Organization Expense is written off against the Reserve for Working Capital, it is equivalent to stating that out of the amount realized from the sale of Donated or Treasury shares, the Organization Expense has been covered and there remains a balance of Working Capital for other purposes. This effect would be more apparent if Organization Expense had been paid for in cash instead of by the issue of shares. There will always be some cash outlay in organizing a company. The Organization Expense may be written off as illustrated under the first method and the Balance Sheet changed accordingly, if desired.

Objection to this Method of Recording Treasury Stock. The objection to this method of recording Treasury shares is that it makes it appear that the company has acquired and holds its own shares, whereas they are held in trust that, when disposed of, the proceeds may be given to the company.

The transfers to the trustee and by the trustee to the purchasers of the shares will be recorded in the transfer books and Share Ledger.

Discount on Mining Company Shares v. Discount on Treasury Stock. The problem that follows serves to illustrate the point to which reference has already been made, that whenTreasury Stock is sold at a price below par there is no discount on shares involved but a reduction in potential Working Capital.

Problem. The Deep Mining Company, Ltd., is incorporated with an authorized capital of $500,000.00 in shares of $1.00 each.

The incorporators receive 200,000 shares in payment for their mining property, and the remainder of the shares are sold at a discount of 40 per cent.

All shareholders then donate 20 per cent. of their holdings, by a transfer to a trustee, that they may be sold to provide further Development Capital.

Raise entries, in journal form, and prepare the Balance Sheet.

Solution.

Subscribers	$200,000.00	
To Capital Stock		$200,000.00
Issue of 200,000 shares at par.		
Mining Property	200,000.00	
To Subscribers		200,000.00
Subscribers	180,000.00	
Discount on Shares	120,000.00	
To Capital Stock		300,000.00
Issue of 300,000 shares at 60 c.		
Cash	180,000.00	
To Subscribers		180,000.00
Treasury Stock	100,000.00	
To Reserve for Development Capital		100,000.00
Donation of 100,000 shares through trustee.		
Purchases of Treasury Shares	50,000.00	
Reserve for Development Capital	50,000.00	
To Treasury Stock		100,000.00
Cash	50,000.00	
To Purchasers of Treasury Shares		50,000.00

THE DEEP MINING COMPANY, LTD.

Balance Sheet

——— —, 19—

Assets

Cash		$230,000.00
Mining Property		200,000.00
		$430,000.00

Shareholders' Equity

Capital Stock—Subscribed and Paid	$500,000.00	
Less : Discount	120,000.00	
	380,000.00	
Reserve for Development Capital	50,000.00	$430,000.00
		$430,000.00

The term Treasury Stock is sometimes found applied to unissued shares, but this application of the term is not generally accepted in Canada as the correct one.

CHAPTER ELEVEN

FORFEITURE OF SHARES

Forfeited Shares. Limited Companies may enforce payment of all calls and interest thereon by action in any court of competent jurisdiction, or they may summarily forfeit the shares whereon such calls have not been paid, provided due notice has been given to the registered holder of these shares.

The effect of such forfeiture is to make the shares forfeited the property of the company, while the registered holder, whose shares have been forfeited, ceases to be a shareholder and therefore loses his rights as a shareholder. The extent to which his liabilities are extinguished depends on the statute under which the company's charter has been issued and possibly on the by-laws. The Canadian Acts are not uniform on this point and, as they are subject to change from time to time, any reference made here to the statute should be verified by recourse to the statute itself.

Under the Dominion Act, at the time of writing, the person whose shares are forfeited has both rights and liabilities as shareholder extinguished as far as the company is concerned, but his liability to creditors, as they are at the time for forfeiture, is not extinguished except in so far as, from time to time, amounts are received on his arrears. When the creditors at the time of forfeiture have been paid, his liability to them would appear to cease.

Some of the Provincial Acts provide that the forfeiture shall not relieve the shareholder from any liability to the company or to any creditor.

Another effect of the forfeiture is to reduce accordingly the issued capital of the company, but on reissuing the shares the company may give credits for payments made prior to forfeiture, so long as the amount received before and after forfeiture equals at least the par value.

Entries in Books of Record. In order that the Share Ledger may contain a proper record of such shares, they should be entered up by transferring the amounts from the defaulting shareholder's account to a special account headed "Forfeited Shares." When they are reissued a similar entry should be made transferring the figures from Forfeited Shares Account to that of the new holder.

Entries in the Financial Books. The entries in the Financial Books can be better brought out by illustration than by discussion, and for this purpose the examples that follow are given, showing the entries under different conditions.

FORFEITURE WHEN AMOUNT DUE FOR PAYMENT, ONLY, IS RECORDED.

Problem. A subscribed for 20 shares, of $100.00 each, in a company. He paid $10.00 a share, payable with application, and $15.00 a share due on allotment, but failed to pay Call 1, of $30.00 a share.

After due notice, A's shares were forfeited. The shares were later reissued to B who paid $40.00 a share, and who is subject to the further calls above the $55.00 already due or called. Make the entries necessary to record the transactions relative to the shares subscribed for by A and forfeited.

Solution—

NOTE. In order that the transactions may be easily followed in their order, the cash entries are given in journal form. Entries are for the shares subscribed for by A only.

Cash	$200.00	
To Applications		$200.00
Receipt of $10.00 a share with application.		
Applications	200.00	
To Capital Stock		200.00
Application accepted.		
Allotment	300.00	
To Capital Stock		300.00
$15.00 a share due on allotment.		
Cash	300.00	
To Allotment		300.00
Payment received, $15.00 a share.		
Subscriber—Call 1	600.00	
To Capital Stock		600.00
Call of 30 per cent.		
Capital Stock	1,100.00	
To Subscriber—Call 1		600.00
,, Forfeited Shares Suspense		500.00
To record forfeiture of 20 shares of A and hold the amount paid in Suspense pending reissue of the shares.		
Subscriber—B	800.00	
Forfeited Shares Suspense	300.00	
To Capital Stock		1,100.00
Reissue of 20 shares, forfeited, to B at $40.00 a share in full for amounts due to date.		
Cash	800.00	
To Subscriber—B		800.00
Payment received.		

Forfeited Shares Suspense	$200.00	
To Premium on Shares		$200.00
To transfer balance of Suspense account to Premium on Shares. This represents the amount received from A, less the amount below par at which the shares are issued to B.		

If entries at the time of forfeiture and reissue, only, are made, they are as follows—

Capital Stock	$1,100.00	
To Call 1		$600.00
,, Forfeited Shares Suspense		500.00
Subscriber—B	800.00	
Forfeited Shares Suspense	300.00	
To Capital Stock		1,100.00
Cash	800.00	
To Subscriber—B		800.00
Forfeited Shares Suspense	200.00	
To Premium on Shares		200.00

An alternative to the credit to Premium on Shares is to transfer the portion of Forfeited Shares Suspense that remains after covering the amount below par at which the shares are reissued, to "Premium on Forfeited Shares." This is not a material point, however. The net effect is that these shares have yielded a premium from their issue and reissue, and the distinction between a premium from the original issue and a premium from reissue after forfeiture is not sufficiently important to require a further special account. There is no real objection, however.

The term "Profit on Forfeited Shares," instead of "Forfeited Shares Suspense," is frequently used, but it is better not to introduce the idea of profit to capital contributions. The amount paid by the original subscriber is merely recorded as in suspense until the shares are reissued, when it becomes known whether or not the whole amount realized is more than par value, and if so, it is then known that a premium has been obtained and the amount ceases to be in suspense. It is an item of Capital Surplus, and so should be kept separate from Earned Surplus.

FORFEITURE—SUBSCRIBED CAPITAL RECORDED.

Problem. The X Company, Ltd., has an authorized capital of $800,000.00, of which $500,000.00 has been subscribed at par. Calls of 20 per cent. and 25 per cent. have been made and paid, except for the second call on A's subscription of 40 shares. After due notice, A's shares are forfeited and are reissued to B, who pays $36.00 a share and is subject to subsequent calls. Raise entries for the above.

Solution.

Subscription	$500,000.00	
To Capital Stock—Subscribed		$500,000.00
Issue of 5,000 shares at par.		
Subscribers—Call 1	100,000.00	
To Subscriptions		100,000.00
Call of 20 per cent.		
Cash	100,000.00	
To Subscribers—Call 1		100,000.00
Payment of Call 1.		
Subscribers—Call 2	125,000.00	
To Subscription		125,000.00
Call of 25 per cent.		
Cash	124,000.00	
To Subscribers—Call 2		124,000.00

NOTE. The above entries give the background, and if posted to ledger accounts would show the position of the company at this point. The entries for the forfeiture and reissue follow.

Capital Stock—Subscribed	$4,000.00	
To Subscription		$2,200.00
,, Subscribers—Call 2		1,000.00
,, Forfeited Shares Suspense		800.00
Forfeiture of 40 shares, $4,000.00, of which $2,200.00 is uncalled, $1,000.00 is called but call unpaid, and $800.00 has been paid.		
Subscription	2,200.00	
Subscriber—B	1,440.00	
Forfeited Shares Suspense	360.00	
To Capital Stock—Subscribed		4,000.00
Reissue of 40 shares, forfeited, for $3,600.00, to be 45 per cent. paid up on payment of $1,440.00.		
Cash	1,440.00	
To Subscriber—B		1,440.00
Payment as per terms of agreement.		
Forfeited Shares Suspense	440.00	
To Premium on Shares		440.00
To close out the balance in Suspense account to Premium account.		

Trial Balance

Dr. Balances	
Cash	$225,440.00
Subscription	275,000.00
	$500,440.00
Cr. Balances	
Capital Stock—Subscribed	$500,000.00
Premium on Shares	440.00
	$500,440.00

Alternative Method. A plan sometimes adopted is to charge an account for Forfeited Shares instead of reducing the recorded Capital Stock. If this were followed the entries would be—

Forfeited Shares	$4,000.00	
To Subscription		$2,200.00
,, Subscribers—Call 2		1,000.00
,, Forfeited Shares Suspense		800.00
Subscription	2,200.00	
Subscriber—B	1,440.00	
Forfeited Shares Suspense	360.00	
To Forfeited Shares		4,000.00
Cash	1,440.00	
To Subscriber B		1,440.00
Forfeited Shares Suspense	400.00	
To Premium on Shares		400.00

Under this method, if a Balance Sheet is prepared between the time of forfeiture and the time of reissue, the amount of Forfeited Shares is deducted from Capital Stock and the net amount extended. Since, however, the forfeiture removes the subscriber from the list of shareholders and the shares become the property of the company, the shares would also appear to be removed from issued share capital and so may be taken out by a direct charge to Capital Stock. Even if, as under some Companies Acts, the subscriber whose shares are forfeited is not relieved from liability to the company for calls made before the forfeiture until contributions are received from reissue, it may be considered that he is held as liable in a special sense under this promise to contribute rather than as a shareholder, and is relieved only when the new purchaser of the shares has made the contribution in his place.

An advantage from charging "Forfeited Shares" Account instead of Capital Stock is that it shows a continuing record of the shares until they are disposed of, and as these may be reissued at less than par, as long as the difference is covered by payments made before forfeiture, they stand in a relation different from unissued shares.

FORFEITURE—AUTHORIZED CAPITAL RECORDED. If the example taken as an illustration when Subscribed Capital is recorded is applied when Authorized Capital is brought into the books, there will be a debit in Unsubscribed Shares of $300,000.00, Subscription $275,000.00, and Subscribers, Call 2, $1,000.00. In this case Capital Stock is not affected, but the charge may be made to Unsubscribed Shares and so increase that amount, or to Forfeited Shares Account. If the charge is made to Forfeited Shares Account, the amount will, in the Balance Sheet, be deducted with unsubscribed shares to arrive at the Paid-up Capital, so the effect is similar.

The entries will be similar to those in the previous example, if Forfeited Shares Account is charged and the Balance Sheet before reissue will be—

THE X COMPANY, LTD.

Balance Sheet

——— —, 19—

	Assets	
Cash		$224,000.00
		$224,000.00
	Shareholders' Equity	
Capital Stock—		
Authorized		$800,000.00
Deduct Unsubscribed	$300,000.00	
Forfeited	4,000.00	304,000.00
Subscribed		496,000.00
Deduct Uncalled		272,800.00
Paid-up Capital		223,200.00
Forfeited Shares Suspense		800.00
		$224,000.00

If the charge is made to Unsubscribed Shares, the entries are—

Unsubscribed Shares	$4,000.00	
To Subscription		$2,200.00
,, Subscribers—Call 2		1,000.00
,, Forfeited Shares Suspense		800.00

NOTE. A Balance Sheet prepared now will be similar to that just shown, except that Unsubscribed Shares will be $304,000.00 without division.

Subscription	$2,200.00	
Subscriber—B	1,440.00	
Forfeited Shares Suspense	360.00	
To Unsubscribed Shares		$4,000.00
Cash	1,440.00	
To Subscriber—B		1,440.00
Forfeited Shares Suspense	440.00	
To Premium on Shares		440.00

THE X COMPANY, LTD.

Balance Sheet

——— —, 19—

Assets

Cash	$225,440.00
	$225,440.00

Shareholders' Equity

Capital Stock—Authorized	$800,000.00
Deduct Unsubscribed	300,000.00
Subscribed	500,000.00
Deduct Uncalled	275,000.00
Paid-up Capital	225,000.00
Premium on Shares (Capital Surplus)	440.00
	$225,440.00

CHAPTER TWELVE

DEBENTURE BONDS AND MORTGAGE BONDS

THERE is considerable confusion in the use of these terms "Debentures" and "Bonds."

A Debenture may be defined as a promise to pay issued in return for money borrowed, the principal payable at a certain specified time to the owner or to bearer, with interest in the meantime at a stated rate. In Great Britain the term "Debenture" is applied whether definite assets have been pledged as security for the return of the loan or not.

Bonds may be defined in terms similar to those given for Debentures, as in each case the issuing corporation has given its bond to pay the amount borrowed.

In Canada, the term Debenture is generally understood to refer to a series of obligations that are unsecured while, if there were definite security, these would be described as bonds. However, the securities issued during the Great War by the Dominion Government were called Victory Bonds whereas, under the above distinction, they were debentures.

Debentures are the form of security usually issued by public corporations, such as Governments and Municipalities, in return for borrowed money. No assets are pledged as security, and the real security in those cases is the tax power.

Some public utility corporations have issued debentures, especially power corporations whose expected output is under long term contracts, so that the security in that case is the earning power. Nothing, however, is pledged.

The term Bond is usually applied when assets are pledged as security for the amount borrowed, and for which the promise to pay has been issued. Thus, industrial corporations issue bonds secured usually by a pledge or mortgage of the fixed assets.

The distinction between the two forms of security may be further expressed as that the first are referred to as Debenture Bonds and the second as Mortgage Bonds. It will be observed that both have the feature of the bond or promise to pay, while one has the mortgage feature in addition, which the other has not. The form of the two may be just the same but one, the mortgage bond, will state the security pledged.

Borrowing by the issue of bonds is a recognized feature in the general financial structure of business corporations, and will be profitable so long as the rate of earning capacity is higher than the rate paid as interest on the bonds. The difference is a benefit to the corporation. In times of depression the reverse may be the effect, because it may take a part of what is earned by the shareholders' contributions to pay the interest on the borrowed money.

If a corporation borrowed $1,000,000.00 it would not expect to obtain this all from one person. It would probably issue 1,000 separate bonds for $1,000.00 each, assuming that the whole amount is to fall due at one time and the bonds were not on the annuity plan. There will be interest coupons attached so that at each interest date the holder may detach the coupons due and present them for payment. It would not be convenient to give each of these 1,000 people, assuming that each had purchased only one bond, a separate mortgage. A mortgage is a deed transferring title, with the provision that if the mortgage loan is paid the title reverts to the mortgagor.

The plan followed is to place the mortgage with a trustee who holds it in trust, hence it is called a Trust Deed, and is held for all the bondholders.

If the bonds are secured by a first mortgage they will be called First Mortgage Bonds, and there may follow Second Mortgage Bonds, etc. The security for the Second Mortgage Bonds will be the equity remaining after the First Mortgage Bonds are satisfied.

Plans of Issue. Debenture Bonds or Mortgage Bonds may be issued on the Annuity plan, in which case equal payments are made annually, or half-yearly, as the case may be, these covering interest on the outstanding principal and a portion of the principal itself. The interest becomes less with each payment and the payment on principal greater. The difficulty with this form is that the amounts falling due each period are likely to be in odd amounts instead of round amounts.

They may be issued on the Serial plan, which is an adaptation from the annuity plan, round amounts of principal being paid at each time, this being to the nearest $100.00 or $1,000.00 that would be possible under the Annuity plan.

This means that the payments for interest and principal together are approximately the same, but not exactly so.

Again, they may be issued on the Sinking Fund plan, in which case the whole amount falls due at one time, and interest is paid on the whole amount in the meantime. Provision in the form of a Sinking Fund will be required to meet the principal of the bonds when they fall due.

The examples that follow will serve to illustrate these points.

Annuity Plan.

Problem. Bonds to the amount of $12,000.00, bearing interest at 5 per cent. per annum, are issued repayable in four equal annual payments covering principal and interest. The annual payment is $3,384.14.

(*a*) Prepare a schedule showing the components of each payment.
(*b*) Assuming that the bonds are issued in denominations of $1,000.00 and odd amounts, prepare a schedule showing the interest coupons attached to each bond, and thus show how each year's interest is made up.

Solution—

(*a*)

	Annual Payment	Interest	Payment on Principal	Balance
1st year .	$3,384.14	$600.00	$2,784.14	$9,215.86
2nd year .	3,384.14	460.79	2,923.35	6,292.51
3rd year .	3,384.14	314.63	3,069.51	3,223.00
4th year .	3,384.14	161.14	3,223.00	*nil*

(*b*)

	Bonds	Interest Coupon Statement			
		1st yr.	2nd yr.	3rd yr.	4th yr.
Bond No. 1 .	$1,000.00	$50.00			
,, ,, 2 .	1,000.00	50.00			
,, ,, 3 .	784.14	39.21			
,, ,, 4 .	1,000.00	50.00	$50.00		
,, ,, 5 .	1,000.00	50.00	50.00		
,, ,, 6 .	923.35	46.17	46.17		
,, ,, 7 .	1,000.00	50.00	50.00	$50.00	
,, ,, 8 .	1,000.00	50.00	50.00	50.00	
,, ,, 9 .	1,000.00	50.00	50.00	50.00	
,, ,, 10 .	69.51	3.48	3.48	3.48	
,, ,, 11 .	1,000.00	50.00	50.00	50.00	$50.00
,, ,, 12 .	1,000.00	50.00	50.00	50.00	50.00
,, ,, 13 .	1,000.00	50.00	50.00	50.00	50.00
,, ,, 14 .	223.00	11.14	11.14	11.15	11.14
	Total	$600.00	$460.79	$314.63	$161.14

From the above it will be observed that the total interest payable at each interest date is made up of the total of the interest coupons on the several bonds outstanding. Fractions of cents have been adjusted.

In practice, to avoid small odd amounts on separate bonds, it is usual if the odd amount is under $300.00, to include it in a bond with $1,000.00 if there is one due at the same time. Thus, in the third year in the above example, there would likely be two bonds of $1,000.00 each and one bond for $1,069.51 instead of three of $1,000.00 each and one for $69.51.

Also, in the fourth year, there would probably be two bonds of $1,000.00 each and one bond for $1,223.00.

The interest coupons for the third bond in the third year would be for $53.48 each, and those for the last bond in the fourth year $61.14, etc.

The odd amount bonds are not usually very popular, as buyers prefer even amounts and, to meet this difficulty, the Serial plan is frequently adopted.

Serial Plan. This is an adaptation or adjustment from the annuity plan with a view to issuing bonds in round amounts only, and thus avoid odd amounts. This plan can be best illustrated in the case of a large issue of $1,000,000.00 or more, although it can be applied to almost any. In a small issue the variation is more in evidence.

Problem. A corporation is issuing $100,000.00 of 4-year, 5 per cent. bonds and desires that these should be paid off, a portion each year, the annual payments of interest and principal together to be as nearly equal as possible, with all bonds in denomination of $1,000.00.

Prepare a schedule of payments to meet these requirements.

Solution. Had this issue been made on the annuity plan the annual payment would have been $28,201.18, and the schedule as follows—

	Annual payment	Interest	Principal	Balance
1st year	$28,201.18	$5,000.00	$23,201.18	$76,798.82
2nd year	28,201.18	3,839.94	24,361.24	52,437.58
3rd year	28,201.18	2,621.88	25,579.30	26,858.28
4th year	28,201.18	1,342.90	26,858.28	*nil*
			$100,000.00	

Schedule adjusted to the Serial plan—

	Annual payment	Interest	Principal	Balance
1st year	$28,000.00	$5,000.00	$23,000.00	$77,000.00
2nd year	27,850.00	3,850.00	24,000.00	53,000.00
3rd year	28,650.00	2,650.00	26,000.00	27,000.00
4th year	28,350.00	1,350.00	27,000.00	*nil*
			$100,000.00	

There is no special calculation after the amounts under the annuity plan are determined, except to adjust to the nearest round amount of principal. Another schedule could be prepared with only a slight net variation, as shown below.

Alternative schedule—

	Annual payment	Interest	Principal	Balance
1st year	$28,000.00	$5,000.00	$23,000.00	$77,000.00
2nd year	28,850.00	3,850.00	25,000.00	52,000.00
3rd year	27,600.00	2,600.00	25,000.00	27,000.00
4th year	28,350.00	1,350.00	27,000.00	*nil*
			$100,000.00	

The variation here is greater, but not seriously so. To observe the variation, compare the annual payments under the Serial plan with the fixed annual payment under the Annuity.

Had it been desired that a few bonds of $100.00 each be issued instead of $1,000.00 denomination only, the schedule might have been made as below—

	Annual payment	Interest	Principal	Balance
1st year	$28,200.00	$5,000.00	$23,200.00	$76,800.00
2nd year	28,240.00	3,840.00	24,400.00	52,400.00
3rd year	28,220.00	2,620.00	25,600.00	26,800.00
4th year	28,140.00	1,340.00	26,800.00	*nil*
			$100,000.00	

There would be 20 bonds of $100.00 each and 98 bonds of $1,000.00 each. This plan is frequently followed, and reduces the variation in the annual payments to very small proportions. A larger number in $100.00 denominations, in multiples of 10 (1,000), could be issued without disturbing the schedule.

Sinking Fund Plan. When bonds are issued under the Sinking Fund plan, the total amount falls due at one time, i.e. if they are 20-year bonds, the total amount falls due at the end of twenty years. Interest is payable, at stated dates, on the full amount throughout the period. In the meantime the corporation that issues the bonds prepares for their payment, when due, by building up a special fund for the purpose. The subject of Sinking Funds will be discussed later.

Problem. A corporation issued $100,000.00 of 4-year, 5 per cent. bonds. What amounts are payable each year? The interest is annual.

Solution. Each year, for 4 years, the corporation will pay $5,000.00 as interest on the bonds. No principal is paid until the period of 4 years has expired, when the full amount is payable. In the meantime, however, the corporation must create a Sinking Fund, paying into it each year such an amount as will, at an estimated rate of interest accumulation, provide $100,000.00 to retire the bonds when they fall due.

Bonds Issued or Purchased at Par

Books of Issuer. When bonds are sold at par, the accounting does not involve any complex features. Entries at issue record cash received and the setting up of the liability. Later entries record payments of interest and, when due, of principal.

Problem. A corporation issued $12,000.00 of 4-year bonds, bearing 5 per cent. interest, on the Annuity plan, at par. Interest is payable annually.

The annual payment is $3,384.14.

Raise entries at the date of issue and at the dates of the payments.

NOTE. This problem is based on the example given earlier to illustrate Annuity bonds.

Solution—

NOTE. That the record of transactions may be followed in their order, all entries are made in journal form.

Entries—

At date of issue—		
Cash	$12,000.00	
To Bonds Payable		$12,000.00
Issue of $12,000.00 bonds at par.		
1st year—		
Interest on Bonds	600.00	
Bonds Payable	2,784.14	
To Cash		3,384.14
Payment due for interest and on account principal.		
2nd year—		
Interest on Bonds	460.79	
Bonds Payable	2,923.35	
To Cash		3,384.14
Payment of interest and principal due.		
3rd year—		
Interest on Bonds	314,63	
Bonds Payable	3,069.51	
To Cash		3,384 14
Payment of interest and principal due.		
4th year—		
Interest on Bonds	161.14	
Bonds Payable	3,223.00	
To Cash		3,384.14
Payment of interest and balance of principal.		

LEDGER

Dr. *Bonds Payable* *Cr.*

1st year	C.	–	$2,784.14	At issue	C.	1	$12,000.00
2nd year	C.	–	2,923.35				
3rd year	C.	–	3,069.51				
4th year	C.	–	3,223.00				
			$12,000.00				$12,000.00

Dr. *Interest on Bonds* *Cr.*

1st year	C.	–	$600.00	1st year	Profit and Loss J.	–	$600.00
2nd year	C.	–	460.79	2nd year	Profit and Loss J.	–	460.79
3rd year	C.	–	314.63	3rd year	Profit and Loss J.	–	314.63
4th year	C.	–	161.14	4th year	Profit and Loss J.	–	161.14

NOTE. In the ledger the proper books of original entry from which postings would be made are indicated.

Books of Purchaser. Assuming that one person holds all of these bonds and purchased them at par, the entries will be just the reverse of those in the books of the issuer. The entries at purchase and at first interest date will be sufficient to illustrate.

Entries—

At date of purchase—		
Bonds	$12,000.00	
To Cash		$12,000.00
Purchased $12,000.00 of bonds at par.		
1st year—		
Cash	3,384.14	
To Interest on Bonds		600.00
,, Bonds		2,784.14
Received payment of interest and portion of principal of bonds.		

One year later, the holder should receive $460.79 interest and $2,923.35 on principal, this being the amount of the three bonds due at the end of the second year.

Bonds are usually distributed more widely and many persons will hold one bond each, only.

If A purchased a $1,000.00 bond due in the third year, his entries would record $50.00 received as interest, only, for each of the first two years and $50.00 interest and $1,000.00 principal received at the end of the third year.

Purchase Between Interest Dates.

Problem. B purchased $3,000.00 of the above bonds due at the end of three years, the purchase being made 4 months after the date of issue. Record the purchase and amounts received up to the date the bonds fall due. The purchase was made at par and accrued interest.

Solution. B has purchased not only three bonds but four months' accrued interest on these bonds. (If dates were given, the accrued interest

would be calculated by days, not by months.) He receives the full year's interest, so if, at the time of purchase, the Interest account is charged with the amount of accrued interest purchased and, when the year's interest is received, Interest account is credited with the full amount, the net amount, \$150.00 – \$50.00 or \$100.00 is the amount earned since purchase. To be exact, B should have paid only the present value of \$50 00, as he waits eight months to recover it, but while this was once the practice, the general rule now is that he pays the accrued interest without deduction.

Entries—

At date of purchase—

Bonds	\$3,000.00	
Interest on Bonds	50.00	
To Cash		\$3,050.00

To record purchase of \$3,000.00 bonds due in 2 years and 8 months, and 4 months' accrued interest.

1st year—

Cash	150.00	
To Interest on Bonds		150.00

Amount received for coupons 8 months after purchase.

2nd year—

Cash	150.00	
To Interest on Bonds		150.00

Received for coupons

3rd year—

Cash	3,150.00	
To Interest on Bonds		150.00
,, Bonds		3,000.00

Received for coupons and for 3 bonds due.

LEDGER

Dr. *Bonds* *Cr.*

(At purchase)	C.	–	\$3,000.00	3rd year	C.	–	\$3,000.00

Dr. *Interest on Bonds* *Cr.*

(At purchase)	C.	–	\$ 50.00	1st year	C.	–	\$150.00
1st year Profit and Loss	J.	–	100.00				
			150.00				150.00
2nd year Profit and Loss	J.	–	150.00	2nd year	C.	–	150.00
3rd year Profit and Loss	J.	–	150.00	3rd year	C.	–	150.00

Bonds Purchased and Sold at a Discount

Debenture Bonds and Mortgage Bonds may be issued at par, at a discount, or at a premium. They are issued with a stated rate of interest on the face amount, but that rate of interest may be found to be lower than investors are willing to accept, having regard to risk, prevailing rate of true interest (rate where there is a minimum of risk, e.g. Canadian Government Bonds), the condition of the money market, and the supply of and demand for bonds of the particular grade in the market.

Should the investor demand a higher rate than that printed on the bonds, he will not pay the full face amount of the bonds but a lower amount, which will adjust the difference in the rate.

Books of Purchaser.

Problem. A purchased $10,000.00 of 5½ per cent bonds having three years to run, interest payable annually, at a price to yield 6 per cent. on the investment. What amount should he pay for the bonds? Prepare a statement showing what amount should be credited to revenue from the investment each year.

Solution. A is not making a 5½ per cent. investment but one to yield 6 per cent.

Since there are $10,000.00 of 5½ per cent. bonds A will receive $550.00 each year for 3 years, and $10,000.00 at the end. It is, therefore, required to find the present value of a 3-year annuity of $550.00 with $10,000.00 at the end of 3 years. Money is worth 6 per cent.

$(1{\cdot}06)^3 = 1{\cdot}19106.$

When the annual payment is $ .06 the F.V. is $.191016

,, ,, ,, $ 1.00 ,, ,, $\$\frac{.191016}{.06}$

,, ,, ,, $550.00 ,, ,, $\$\frac{.191016}{.06} \times 550$

$= \$\ 1,750.98$

Add Principal 10,000.00

$11,750.98

P. W. of $1.191016 in 3 years = $1.00

,, $11,750.98 ,, ,, $= \$\frac{11,750.98}{1.191016} = \$9,866.35$ = Amount Paid

			Short
1st year.	A receives \$550.00. Interest on \$9,866.35 @ 6% =	\$591.98	\$41.98
	Investment now is \$9,866.35 + \$41.98 = \$9,908.33		
2nd year.	A receives \$550.00. Interest on \$9,908.33 @ 6% =	594.50	44.50
	Investment now is \$9,908.33 + \$44.50 = \$9,952.83		
3rd year.	A receives \$550.00. Interest on \$9,952.83 6% =	597.17	47.17
	Total Revenue	\$1,783.65	
	Received of this	1,650.00	
	Shortage		\$133.65
	Paid for Bonds	\$9,866.35	
	Received	10,000.00	
	Received back investment of		\$ 9,866.35
	and accumulated interest		133.65
	Making up		\$10,000.00

From the above it is seen that A bought \$10,000.00 of bonds for \$9,866.35, or at a discount of \$133.65.

What he has actually done is to invest \$9,866.35 in bonds to yield 6 per cent, while, although the annual effective interest is more than \$550.00, because of what is printed on the bonds he receives only \$550.00 per annum on account of interest. The balance is added to the investment and accumulates at the same rate of interest.

The entry when he makes the purchase may be—

(*a*)	Bonds	\$ 9,866.35	
	To Cash		\$9,866.35
	or		
(*b*	Bonds	10,000.00	
	To Cash		9,866.35
	,, Discount on Bonds		133.65

Entries for (*a*) as shown in the accounts—

Dr. *Bonds* *Cr.*

(At Purchase)	Cash	\$9,866.35	End of 1st year	Cash	\$550.00
1st year	Interest 6%	591.98		Balance	9,908.33
		\$10,458.33			\$10,458.33
	Balance	\$9,908.33	End of 2nd year	Cash	\$550.00
2nd year	Interest 6%	594.50		Balance	9,952.83
		\$10,502.83			\$10,502.83
	Balance	\$9,952.83	End of 3rd year	Cash	\$550.00
3rd year	Interest 6%	597.17	,, ,, ,,	Cash	10,000.00
		\$10,550.00			\$10,550,00

1st year—		
Bonds	$591.98	
To Interest on Bonds		$591.98
6% on $9,866.35		
Cash	550.00	
To Bonds		550.00
2nd year—		
Bonds	594.50	
To Interest on Bonds		594.50
6% on $9,908.33.		
Cash	550.00	
To Bonds		550.00
3rd year—		
Bonds	597.17	
To Interest on Bonds		597.17
6% on $9,952.83.		
Cash	550.00	
To Bonds		550.00
Cash	10,000.00	
To Bonds		10,000.00

The increase in the balance each year represents the addition through part of the interest not yet received, and which will bear interest at the same rate. A student should himself make all these calculations.

The interest on bonds will each year be closed out to Profit and Loss as revenue.

Entries and accounts under method (*b*)—

Dr. *Bonds* *Cr.*

(At purchase)	Cash C.	–	$9,866.35	End of 3rd year	Cash	$10,000.00
,,	Discount J.	–	133.65			
			$10,000.00			$10,000.00

Dr. *Discount on Bonds* *Cr.*

1st year	Interest on Bonds	$41.98	Bonds Account	$133.65
2nd year	Interest on Bonds	44.50		
3rd year	Interest on Bonds	47.17		
		$133.65		$133.65

1st year—		
Cash	$550.00	
To Interest on Bonds		$550.00
To record cash received for interest coupons.		

This amount, however, does not cover interest on the basis on which the investment was made, as 6 per cent. on $9,866.35 is $591.98. The discount was allowed to adjust the interest so a transfer entry will be made—

Discount on Bonds	$41.98	
To Interest on Bonds		$41.98
To transfer from Discount account to Interest account the difference between the amount received and the interest earned.		
2nd year—		
Cash	550.00	
To Interest on Bonds		550.00
Discount on Bonds	44.50	
To Interest on Bonds		44.50
Interest on $9,908.33 at 6% is $594.50. Received only $550.00. Adjusted by transfer from discount.		
3rd year—		
Cash	550.00	
To Interest on Bonds		550.00
Discount on Bonds	47.17	
To Interest on Bonds		47.17
Interest for year on $9,952.83 at 6% is $597.17. Amount received is only $550.00. This is adjusted by transfer from Discount on Bonds.		
Cash	10,000.00	
To Bonds		10,000.00
Received payment of Bonds.		

This amount of $10,000.00 represents the original investment of $9,866.55 and the amount of interest earned in excess of the amount received from coupons.

The above illustration brings out the fact that the discount is just the adjustment between the rate printed on the bonds, which enables us to calculate how much will be received each year, and the rate at which the investment is actually made. The reason for the discount in this case lies in the fact that the rate set out in the by-law, and so printed on the bonds, is 5½ per cent., whereas the market rate for such securities is 6 per cent., and so the issuer borrows only $9,866.35 instead of $10,000.00 and when he pays $10,000.00 when the bonds are due, he is paying back what he borrowed plus arrears of interest, and interest on the arrears.

Books of Issuer. The corporation issuing bonds at a discount will set up the liability at the full amount, with the discount recorded in a separate account. While the present liability on the basis of issue price would be the net amount, should the corporation default or cease operations, the full face amount would be payable. The annual entries are the reverse of those shown as in the books of the purchaser.

Problem. A corporation issued $10,000.00 of 5½ per cent. bonds having three years to run, interest payable annually, at a price to cost 6 per cent. interest. Record the entries for the issue and at the interest dates.

Solution. At the time of issue the corporation receives $9,866.35 and actually borrows that amount at 6 per cent. interest.

Entry in journal form—

Cash	$9,866.35	
To Bonds Payable		$9,866.35
Discount on Bonds	133.65	
To Bonds Payable		133.65
1st year—		
Interest on Bonds	550.00	
To Cash		550.00
Interest on Bonds	41.98	
To Discount on Bonds		41.98
2nd year—		
Interest on Bonds	550.00	
To Cash		550.00
Interest on Bonds	44.50	
To Discount on Bonds		44.50
3rd year—		
Interest on Bonds	550.00	
To Cash		550.00
Interest on Bonds	47.17	
To Discount on Bonds		47.17

The calculations and explanations for the adjustments are the same as those already given.

Dr. *Bonds Payable* *Cr.*

3rd year	C.	–	$10,000.00	(At date of issue)	C.	–	$9,866.35
				,, ,,	Disct. J.	–	133.65
			$10,000.00				$10,000.00

Dr. *Discount on Bonds* *Cr.*

(At date of issue)		$133.65	1st year Interest on Bonds	J.	–	$41.98
			2nd year Interest on Bonds	J.	–	44.50
			3rd year Interest on Bonds	J.	–	47.17
		$133.65				$133.65

Dr. *Interest on Bonds* *Cr.*

1st year		C.	–	$550.00	1st year Profit and Loss	J.	–	$591.98
,,	Discount	J.	–	41.98				
				$591.98				$591.98
2nd year		C.	–	$550.00	2nd year Profit and Loss	J.	–	$594.50
,,	Discount	J.	–	44.50				
				$594.50				$594.50
3rd year		C.	–	$550.00	3rd year Profit and Loss	J.	–	$597.17
,,	Discount	J.	–	47.17				
				$597.17				$597.17

Approximate Methods for Amortizing Discount. The methods outlined are on a mathematically exact basis, and would usually be followed by financial institutions. In practice, commercial and industrial corporations very often write off a proportionate amount of the discount on the basis of time instead of amortizing it on an exact basis. If that method were employed in this example, the amount of discount written off each year would be one-third, i.e. $\$\frac{133.65}{3} = \$44.55$.

Should a portion of the bonds be paid each year and the approximate method used instead of exact amortization, the discount is written off in a way that charges each year on the basis of the amount outstanding during that year.

If $10,000.00 of bonds were issued with $1,000.00, $2,000.00, $3,000.00, and $4,000.00 payable in respective years, on principal, and the bonds were issued at 97, there is a discount of $300.00. The first year has the use of $10,000.00 (face amount), the second year $9,000.00, the third year $7,000.00, and the fourth year $4,000.00, a total of $30,000.00. The amount written off the discount in the first year is $\frac{10000}{30000}$ of $\frac{300}{1} = \$100.00$, the second year $\frac{9000}{30000}$ of $\frac{300}{1} = \$90.00$, the third year $\frac{7000}{30000}$ of $\frac{300}{1} = \$40.00$.

In the Balance Sheet. In the Balance Sheet of the issuer, the Bonds will appear at their face amount as a Funded or Fixed or Deferred Liability, except for any amount due for payment, which is Current, and the Discount on Bonds shown on the Asset side as a Deferred Charge. The Discount is not an immediate expense or loss.

Bonds Issued at a Premium

Bonds are issued at a premium when the stated rate (printed on the bonds and provided for in the by-law) is higher than the rate demanded by the investment market for that grade of security. The premium adjusts the difference between the stated rate and the rate they are issued to yield, as in the case of a discount but with the opposite effect The premium is not treated as a profit.

Books of Purchaser.

Problem. A purchased $10,000.00 of $5\frac{1}{2}$ per cent. bonds having three years to run, interest payable annually, at a price to yield him 5 per cent. on his investment. Record the purchase and further transactions. The amount paid is $10,136.16. There is an actual investment of this amount at 5 per cent. interest.

Assume (*a*) That no account is opened for the premium;

(*b*) That the premium is recorded in a separate account.

Solution. (*a*)

Dr. *Bonds* *Cr.*

(At purchase)	Cash	$10,136.16	End of 1st year	Cash	$550.00
1st year	Interest 5%	506.81		Balance	10,092.97
		$10,642.97			$10,642.97
	Balance	$10,092.97	End of 2nd year	Cash	$550.00
2nd year	Interest 5%	504.65		Balance	10,047.62
		$10,597.62			$10,597.62
	Balance	$10,047.62	End of 3rd year	Cash	$550.00
3rd year	Interest 5%	502.38	,, ,,	Cash	10,000.00
		$10,550.00			$10,550.00

1st year—

Bonds	$506.81	
To Interest on Bonds		$506.81
5% on $10,136.16.		
Cash	550.00	
To Bonds		550.00

2nd year—

Bonds	504.65	
To Interest on Bonds		504.65
5% on $10,092.97.		
Cash	550.00	
To Bonds		550.00

3rd year—		
Bonds	$502.38	
To Interest on Bonds		$502.38
5% on $10,047.62.		
Cash	550.00	
To Bonds		550.00
Cash	10,000.00	
To Bonds		10,000.00

Solution. (*b*)

Dr. *Bonds* *Cr.*

(At purchase) Cash	$10,000.00	Third year Cash	$10,000.00

Dr. *Premium on Bonds* *Cr.*

(At purchase) Cash	$136.16	1st year Cash	$43.19
		2nd year Cash	45.35
		3rd year Cash	47.62
	$136.16		$136.16

1st year—		
Cash	$550.00	
To Interest on Bonds		$506.81
,, Premium on Bonds		43.19
2nd year—		
Cash	550.00	
To Interest on Bonds		504.65
,, Premium on Bonds		43.35
3rd year—		
Cash	550.00	
To Interest on Bonds		502.38
,, Premium on Bonds		47.62
Cash	10,000.00	
To Bonds		10,000.00

An alternative method is to credit the full amount received, $550.00, to Interest from the Cash Book and follow with a journal entry transferring from the Premium Account the amount of the adjustment, i.e. $43.19, $45.35, and $47.62.

Books of Issuer. The issuer will record the issue in Bonds Payable at par and record the premium in a separate account. Adjustments are made from the Premium Account to the credit of Interest to bring the charge to the effective amount, or cash payments for coupons may be divided as shown in the books of the purchaser. The former method is employed here to illustrate.

Problem. A corporation issued $10,000.00 of 5½ per cent. bonds having three years to run, interest payable annually, at a price to cost 5 per cent. Record the issue and later transactions. The amount received is $10,136.16.

Solution. Entries (all in journal form)—

At Issue—		
Cash	$10,136.16	
To Bonds Payable		$10,000.00
,, Premium on Bonds		136.16
Issue of $10,000.00 Bonds, 5½% at cost of 5%.		
1st year—		
Interest on Bonds	550.00	
To Cash		550.00
Payment of coupons.		
Premium on Bonds	43.19	
To Interest on Bonds		43.19
To adjust interest charge to effective amount.		
2nd year—		
Interest on Bonds	550.00	
To Cash		550.00
Payment of coupons.		
Premium on Bonds	45.35	
To Interest on Bonds		45.35
To adjust interest charge.		
3rd year—		
Interest on Bonds	550.00	
To Cash		550.00
Payment of coupons.		
Premium on Bonds	47.62	
To Interest on Bonds		47.62
To adjust interest charge.		

LEDGER ACCOUNTS

Dr. *Bonds* *Cr.*

			At issue	C.	–	$10,000.00

Dr. *Premium on Bonds* *Cr.*

1st year Interest on Bonds J.	–	$43.19	At issue	C.		$136.16
2nd year Interest on Bonds J.	–	45.35				
3rd year Interest on Bonds J.	–	47.62				
		$136.16				$136.16

Dr.				*Interest on Bonds*			Cr.
1st year	C.	–	$550.00	1st year Premiums on Bonds	J.	–	$43.19
				,, Profit and Loss	J.	–	506.81
			$550.00				$550.00
2nd year	C.	–	$550.00	2nd year Premium on Bonds	J.	–	$45.35
				,, Profit and Loss	J.	–	504.65
			$550.00				$550.00
3rd year	C.	–	$550.00	3rd year Premium on Bonds	J.	–	$47.62
				,, Profit and Loss	J.	–	502.38
			$550.00				$550.00

Had the corporation made approximate adjustments instead of exact, the amount transferred from Premium to Interest each year would have been $\frac{136 \cdot 16}{3}$ or $45.31 for each of two years and $45.38 for the other.

Interest Payable Half-Yearly

The usual practice now, is to pay interest on bonds half-yearly, especially in the case of large issues. When, say, 5 per cent. bonds are issued with interest payable half-yearly, the effective rate is slightly above 5 per cent., i.e. $(1 \cdot 025)^2 - 1 = \cdot 050625$ or $5 \cdot 0625$ per cent. In such a case the number of periods is doubled, while the amount and rate for the period are one-half.

Issue at Par.

Problem. A corporation issued $10,000.00 of 5 per cent. bonds with two years to run, at par. Interest is payable half-yearly. Record the issue and the subsequent transactions.

Explanation. The half-yearly interest is $250.00 and the entries are recorded at the end of each six months instead of annually. The amount of interest written off to Profit and Loss at the end of each year is $500.00, covering two interest payments. A repetition of the entries is unnecessary.

Issue at a Discount.

Problem. A corporation issued $10,000.00 of 5 per cent. bonds having two years to run, interest payable half-yearly, at a price to yield the purchaser $5\frac{1}{2}$ per cent on his investments, thus costing the corporation $5\frac{1}{2}$ per cent.

(*a*) Record the issue and subsequent transactions in the books of the corporation.

(*b*) Record the purchase and subsequent transactions in the books of the purchaser.

Solution. (*a*) The amount received for the issue is $9,906.51. Discount is $93.49.

Entries (all expressed in journal form) are—

At issue—		
Cash	$9,906.51	
To Bonds Payable		$9,906.51
Payment received for bonds.		
Discount on Bonds	93.49	
To Bonds Payable		93.49
To record discount allowed as adjustment of interest rate.		
1st six months—		
Interest on Bonds	250.00	
To Cash		250.00
Payment of interest coupons.		
Interest on Bonds	22.43	
To Discount on Bonds		22.43
Transfer from Discount to adjust Interest to actual cost.		
2nd six months—		
Interest on Bonds	250.00	
To Cash		250.00
Interest on Bonds	23.05	
To Discount on Bonds		23.05
Profit and Loss	545.48	
To Interest on Bonds		545.48
To close Interest account at end of year.		

Solution. (*b*) As the method of accounting procedure has been illustrated in other examples, only the accounts for the Bonds and Interest are given. If a Discount Account were opened the entries would be the reverse of those in (*a*).

Dr. *Bonds* *Cr.*

(At purchase)	C.	–	$9,906.51	1st six months			
1st six months				Cash received	C.	–	$250.00
Interest $2\frac{3}{4}$%	J.	–	272.43	Balance			9,928.94
			$10,178.94				$10,178.94
Balance			$9,928.94	2nd six months			
2nd six months				Cash received	C.	–	$250.00
Interest $2\frac{3}{4}$%	J.	–	273.05	Balance			9,951.99
			$10,201.99				$10,301.99
Balance			$9,951.99	3rd six months			
3rd six months				Cash received	C.	–	$250.00
Interest $2\frac{3}{4}$%	J.	–	273.68	Balance			9,975.67
			$10,225.67				$10,225.67
Balance			$9,975.67	4th six months			
4th six months				Cash received	C.	–	$250.00
Interest $2\frac{3}{4}$%	J.	–	274.33	Cash received	C.	–	10,000.00
			$10,250.00				$10,250.00

Dr. *Interest (Earned) on Bonds* *Cr.*

End 1st year, Profit and Loss	J.	–	$545.48	1st six months Bonds	J.	–	$272.43
				2nd six months Bonds	J.	–	273.05
			$545.48				$545.48
End 2nd year, Profit and Loss	J.	–	$548.01	3rd six months Bonds	J.	–	$273.68
				4th six months Bonds	J.	–	274.33
			$548.01				$548.01

Issue at a Premium. Had the above issue been made at a price to cost $4\frac{1}{2}$ per cent. the amount realized would have been $10,094.62 or at a premium of $94.62. The accounts, without original entries, are given to illustrate.

Books of Issuer.

Dr. *Bonds Payable* *Cr.*

End of 2 years	C.	–	$10,000.00	At issue	C.	–	$10,000.00

Dr. *Premium on Bonds* *Cr.*

1st six months Interest on Bonds	J.	–	$22.87	At issue	C.	–	$94.62
2nd six months Interest on Bonds	J.	–	23.39				
3rd six months Interest on Bonds	J.	–	23.91				
4th six months Interest on Bonds	J.	–	24.45				
			$94.62				$94.62

Dr. *Interest on Bonds* *Cr.*

1st six months	C.	–	$250.00	1st six months Premium on Bonds	J.	–	$22.87
2nd six months	C.	–	250.00	2nd six months Premium on Bonds	J.	–	23.39
				Profit and Loss			453.74
			$500.00				$500.00
3rd six months	C.	–	$250.00	3rd six months Premium on Bonds	J.	–	$23.91
4th six months	C.	–	250.00	4th six months Premium on Bonds	J.	–	24.45
				Profit and Loss			451.64
			$500.00				$500.00

The effect of the above is that the amount paid when coupons were cashed covered the effective interest and a portion of the premium as well. Had the premium been written off in approximate amounts instead of by exact calculation the amount for each six months would have been $\frac{94.62}{4}$ or at the end of each year $\frac{94.62}{2} = \$47.31$.

Books of Purchaser. In this illustration, also, the accounts only are given, as the accounting procedure has been outlined in other examples. The method followed is that of recording the bonds at cost, no premium account being used.

Dr. *Bonds (Investment)* *Cr.*

(At purchase)	C.	–	$10,094.62	1st six months			
1st six months				Cash received	C.	–	$250.00
Interest 2¼%			227.13	Balance			10,071.75
			$10,321.75				$10,321.75
Balance			$10,071.75	2nd six months			
2nd six months				Cash received	C.	–	$250.00
Interest 2¼%			226.61	Balance			10,048.36
			$10,298.36				$10,298.36
Balance			$10,048.36	3rd six months			
3rd six months				Cash received	C.	–	$250.00
Interest 2¼%			226.09	Balance			10,024.45
			$10,274.45				$10,274.45
Balance			$10,024.45	4th six months			
4th six months				Cash received	C.	–	$250.00
Interest 2¼%			225.55	4th six months			
				Cash received	C.	–	10,000.00
			$10,250.00				$10,250.00

Dr. *Interest on Bonds* *Cr.*

1st year Profit and Loss	J.	–	$453.74	1st six months			
				Bonds Account	J.	–	$227.13
				2nd six months			
				Bonds Account	J.	–	226.61
			$453.74				$453.74
2nd year Profit and Loss	J.	–	$451.64	3rd six months			
				Bonds Account	J.	–	$226.09
				4th six months			
				Bonds Account	J.		225.55
			$451.64				$451.64

The purchaser invested $10,094.62 at 4½ per cent. payable half-yearly.

Bonds Purchased Between Interest Dates at Discount or Premium

When bonds are purchased between interest dates, there is a purchase not only of the bond but of the accrued interest as well.

Different methods are followed in practice in calculating the amount payable, these usually varying with the time the bonds have to run, but the differences are slight.

One method, usually accepted as sound, and referred to as the "true method," is to find the value of the bonds, on the basis they are to yield the purchaser, as at the last interest date, add interest on this at the rate of actual yield to the date of purchase and deduct bank discount from this interest to the next interest date.

Purchase at a Discount.

Problem. A purchased $10,000.00 of 5 per cent. bonds, interest payable half-yearly, with one year and nine months to run, at a price to yield $5\frac{1}{2}$ per cent. on the investment.

Record the purchase and subsequent transaction.

Solution (without Discount Account).

The amount payable for principal three months back (date of last interest) is, as shown in other examples given,		$9,906.51
Interest at $5\frac{1}{2}$% for three months (last interest date to purchase)	$136.21	
Less Bank Discount on $136.21 for three months (from date of purchase to next interest date) at $5\frac{1}{2}$%	1.87	134.34
Amount Paid		$10,040.85

NOTE. Had the date been given the calculation would be made by days.

Entry at purchase (in journal form)—

Bonds (Investment)	$10,040.85	
To Cash		$10,040.85
Amount paid as present value of bonds.		

1st interest date—

Bonds	138.06	
To Interest Earned on Bonds		138.06
Interest at $5\frac{1}{2}$% on $10,040.85 for three months.		
Cash	250.00	
To Bonds		250.00
Amount received.		

2nd interest date—

Bonds	$273.05	
To Interest Earned on Bonds		$273.05
5½%, 6 months on $9,928.91.		
Cash	250.00	
To Bonds		250.00

3rd interest date—

Bonds	273.68	
To Interest Earned on Bonds		273.68
5½%, 6 months on $9,951.96		
Cash	250.00	
To Bonds		250.00

4th interest date—

Bonds	274.36	
To Interest Earned on Bonds		274.36
5½%, 6 months on $9,975.64.		
Cash	10,250.00	
To Bonds		10,250.00
Payment received for Bonds and interest coupons.		

LEDGER

Dr. *Bonds* (*Investment*) *Cr.*

(At purchase)	C.	–	$10,040.85	1st Interest date			
1st Interest date Interest	J.	–	138.06	Cash received	C.	–	$250.00
				Balance			9,928.91
			$10,178.91				$10,178.91
Balance			$9,928.91	2nd Interest date			
2nd Interest date Interest	J.	–	273.05	Cash received	C.	–	$250.00
				Balance			9,951.96
			$10,201.96				$10,201.96
Balance			$9,951.96	3rd Interest date			
3rd Interest date Interest	J.	–	273.68	Cash received	C.	–	$250.00
				Balance			9,975.64
			$10,225.64				$10,225.64
Balance			$9,975.64	4th Interest date			
4th Interest date Interest	J.	–	274.36	Cash received	C.	–	$10,250.00
			$10,250.00				$10,250.00

An adjustment of three cents has been made in the last interest.

With dates given, accrued interest and bank discount will be calculated by days.

Solution (with a Discount Account). Had a Discount Account been

opened the charge to Bonds Account at purchase would have been $10,000.00, the charge to Interest Account $134.34, and the credit to Discount Account $93.49.

LEDGER

Dr. *Bonds (Investment)* *Cr.*

(At purchase) Cash paid C.	–	$9,906.51	4th Interest date Cash received C.	–	$10,000.00
(At purchase) Discount J.	–	93.49			
		$10,000.00			$10,000.00

Dr. *Discount on Bonds* *Cr.*

1st Interest date Adjustment	J.	–	$22.40	At purchase	J.	–	$93.49
2nd Interest date Adjustment	J.	–	23.05				
3rd Interest date Adjustment	J.	–	23.68				
4th Interest date Adjustment	J.	–	24.36				
			$93.49				$93.49

Dr. *Interest Earned on Bonds* *Cr.*

(At purchase Interest accrued	C.	–	$134.34	1st Interest date Cash received	C.	–	$250.00
1st Interest date Profit and Loss	J.	–	138.06	1st Interest date Discount	J.	–	22.40
			$272.40				$272.40
2nd Interest date Profit and Loss	J.	–	$273.05	2nd Interest date Cash received	C.	–	$250.00
				2nd Interest date Discount	J.	–	23.05
			$273.05				$273.05
3rd Interest date Profit and Loss	J.	–	$273.68	3rd Interest date Cash received	C.	–	$250.00
				3rd Interest date Discount	J.	–	23.68
			$273.68				$273.68
4th Interest date Profit and Loss	J.	–	$274.36	4th Interest date Cash received	C.	–	$250.00
				4th Interest date Discount	J.	–	24.36
			$274.36				$274.36

The Interest Account would be closed at the end of the year only, but the above better shows interest revenue.

Alternative Method. Under another method, commonly used in practice, the amount paid for the bond principal is $9,916.80 and accrued interest is taken at its face amount $125.00, a total of $10,041.80. Interest for the next three months is taken on $9,916.80 = $136.36. The purchaser merely waits for the return of $125.00 accrued at the next interest date. The amount $9,916.80 is worked out from bond tables. Had the calculation been carried out to further decimal places the difference at the end would be reduced.

Dr. *Bonds (Investment)* *Cr.*

(At purchase)			$10,041.80	1st Interest date			
1st Interest date				Cash received	C.	–	$250.00
Interest accrued	J.	–	136.36	Balance			9,928.16
			$10,178.16				$10,178.16
Balance			$9,928.16	2nd Interest date			
2nd Interest date				Cash received	C.	–	$250.00
Interest accrued	J.	–	273.02	Balance			9,951.18
			$10,201.18				$10,201.18
Balance			$9,951.18	3rd Interest date			
3rd Interest date				Cash received	C.		$250.00
Interest accrued	J.	–	273.66	Balance			9,974.84
			$10,224.66				$10,224.84
Balance			$9,974.84	4th Interest date			
4th Interest date				Cash received	C.	–	$10,250.00
Interest accrued	J.	–	274.31				
Interest adjustment	J.	–	.85				
			$10,250.00				$10,250.00

The adjustment of 85 cents in the last period is necessary to close the account, as the method is approximate. The discount under this method is only $83.20, and is amortized in amounts of $11.36, $23.02, $23.66, and $25.16. The amortization in the broken period under this method is more in accord with the time than under the former method where amortization gave an adjustment for six months.

Purchase at a Premium.

Problem. Assuming that the purchase of $10,000.00 of 5 per cent. bonds, having one year and nine months to run, had been made to yield 4½ per cent. on the investment, record the necessary entries.

Solution. Following the first method, the value at the last coupon date, on a 4½ per cent. payable half-yearly basis, is

		$10,094.62
Interest for past three months on $10,094.62 at 4½%	$113.56	
Less Bank Discount for next three months at 4½%	1.28	112.28
Total amount paid		$10,206.90

The original entries need not be repeated. The ledger accounts show the procedure.

Dr.			*Bonds (Investment)*				*Cr.*
At purchase) Amount paid	C.	–	$10,206.90	1st Interest date Cash received	C.	–	$250.00
1st Interest date Interest earned	J.	–	114.83	Balance			10,071.73
			$10,321.73				$10,321.73
Balance			$10,071.73	2nd Interest date Cash received	C.	–	$250.00
2nd Interest date Interest earned	J.	–	226.61	Balance			10,048.34
			$10,298.34				$10,298.34
Balance			$10,048.34	3rd Interest date Cash received	C.	–	$250.00
3rd Interest date Interest Earned	J.	–	226.09	Balance			10,024.43
			$10,274.43				$10,274.43
Balance			$10,024.43	4th Interest date Cash received	C.	–	$10,250.00
4th Interest date Interest earned	J.	–	225.57				
			$10,250.00				$10,250.00

Adjustment of two cents has been made in last interest.

If a Premium Account had been opened the charge to Bonds would be $10,000.00, the debit to Premium $94.62 and charge to Interest (accrued amount) $112.28. The amortization of premium works out as indicated in the accounts for Premium and Interest that follow.

Dr.			*Premium on Bonds*				*Cr.*
(At purchase)			$94.62	1st date Interest a/c	J.	–	$22.89
				2nd date Interest a/c	J.	–	23.39
				3rd date Interest a/c	J.	–	23.91
				4th date Interest a/c	J.	–	24.43
			$94.62				$94.62

Dr.			*Interest on Bonds*				*Cr.*
(At purchase) Accrued			$112.28	1st date Cash received	C.	–	$250.00
1st date Interest earned	J.	–	114.83				
Premium a/c	J.	–	22.89				
			$250.00				$250.00
2nd date Interest earned	J.	–	$226.61	2nd date Cash received	C.	–	$250.00
Premium a/c	J.	–	23.39				
			$250.00				$250.00
3rd date Interest earned	J.		$226.09	3rd date Cash received	C.	–	$250.00
Premium a/c	J.	–	23.91				
			$250.00				$250.00
4th date Interest earned	J.	–	$225.57	4th date Cash received	C.	–	$250.00
Premium a/c	J.	–	24.43				
			$250.00				$250.00

Alternative Method. No Premium Account. Under the plan generally followed in practice for short terms, except where the true method is required, the amount paid to yield 4½ per cent. would be $10,082.55, plus interest accrued $125.00

Dr. *Bonds* (*Investment*) *Cr.*

(At purchase) 10,082.55				1st Interest date			
125.00	C.	–	$10,207.55	Cash received	C.	–	$250.00
1st Interest date				Balance			10,072.38
Int. 3 mos. 4½%			114.83				
			$10,322.38				$10,322.38
Balance			$10,072.38	2nd Interest date			
2nd Interest date				Cash received	C.	–	$250.00
Int. 6 mos. 4½%			226.63	Balance			10,049.01
			$10,299.01				$10,299.01
Balance			$10,049.01	3rd Interest date			
3rd Interest date				Cash received	C.		$250.00
Int. 6 mos. 4½%			226.13	Balance			10,025.14
			$10,275.14				$10,275.14
Balance			$10,025.14	4th Interest date			
4th Interest date				Cash received	C.	–	$10,250.00
Int. 6 mos. 4½% 225.56							
Less adjustment .70			224.86				
			$10,250.00				$10,250.00

Premium Account. Had a Premium Account been opened the charge to Bonds Account would be $10,000.00, charge to Premium $82.55 and to Interest (accrued) $125.00. The adjustments between Interest and Premium would be $10.17, $23.37, $23.87. and $25.14 respectively.

It will be observed that while different methods followed in practice appear to vary considerably at the beginning, they work out to practically the same results.

CHAPTER THIRTEEN

SINKING FUNDS

A Sinking Fund is a fund built up by setting aside, at regular intervals, certain amounts. These amounts, with interest accumulations at a stated rate, should give the sum required at a certain date to pay a debt then due, or for other purposes.

While the idea of Sinking Funds would generally indicate that the object is to repay a debt, the term is applied also to amounts accumulated with a view to having funds available at a certain time to meet some express purpose.

The fund may be built up for the purpose of having money available to replace a fixed asset or for a payment of a premium on the renewal of a lease, etc.

If a bond issue for $500,000.00 is issued on the Sinking Fund plan for a period of twenty years, the whole amount of the principal falls due at that time, and provision would be made by way of a Sinking Fund to have the money available to meet it when it falls due.

In the same way, it may be desired to have funds available when an asset is worn out, or has wasted through depletion, to replace it at that time.

The problem in either case is to determine the amount that must be set aside at regular intervals (usually annually) and invested so that the interest accumulations at the rate that is taken in calculating the annuity, together with the amounts set aside, will provide the amount required.

The accounting features are not quite the same when the purpose of the fund is to pay a debt as when it is to replace a depreciating or wasting asset. For this reason, these two phases will be dealt with separately.

Sinking Funds for Replacement of Assets

When a Sinking Fund is built up to provide for the replacement of assets, the effect is that depreciation is being provided for on the Sinking Fund plan. Usually, provision for depreciation is indicated only by a book entry. When it is provided for on the Sinking Fund plan the amount of the provision will be taken out of the business and put into the fund.

Depreciation Provision Realized in Current Assets. As a preliminary to the study of this plan it is well to understand that if there is not a net loss after depreciation, the amount charged to operations as provision

for depreciation is realized in the form of current assets. When this is understood it will be clear that it should be possible to take the amounts out of the business and set them aside in an investment without curtailing the working capital.

While the example purposely omits many factors that arise, it may be supposed that a Limited Company, after formation and issue of shares, has \$500,000.00, of which \$300,000.00 is applied to acquire fixed assets and \$200,000.00 remains as working capital. This amount of \$200,000.00 is used to pay for material, wages, and all expense outlay and, in addition, a charge of \$12,000.00 is made to operations to cover depreciation on fixed assets, making a total of \$212,000.00. The product is sold for \$260,000.00, thus indicating a net profit of \$48,000.00, all of which is distributed as dividends.

As sales are realized in the form of current assets—cash or receivables—it follows that \$260,000.00 was realized in current assets, of which \$48,000.00 has been given out, thus leaving \$212,000.00 on hand. The Balance Sheet position is—

THE X COMPANY, LTD.

Balance Sheet

———— ——, 19—

Assets		
Sundry Current		\$212,000.00
Sundry Fixed	\$300,000.00	
Less Reserve for Depreciation	12,000.00	288,000.00
		\$500,000.00
Shareholders' Equity		
Capital Stock—		
Subscribed and Paid		\$500,000.00
		\$500,000.00

It will be observed that fixed assets are recorded at a depreciated value of \$12,000.00 less than at the beginning, while current assets are correspondingly increased. The \$260,000.00 realized from sales gave back \$200,000.00 outlay plus \$12,000.00 provided for depreciation, plus \$48,000.00 profits. It would then be possible to take \$12,000.00 out of the business and place it in a Sinking Fund toward replacing the fixed assets when they wear out and still have the same working capital as at the beginning of the year.

Since, when a Sinking Fund is created for the purpose of providing for the replacement of fixed assets, the amount taken out and put into the investment fund is the amount provided for depreciation of the assets and realized in the form of current assets, the depreciation reserve should indicate the amount that should be in the investment account. To indicate that there is an investment fund the name "Sinking Fund Reserve" may be appropriate instead of "Depreciation Reserve."

Problem. A company acquires buildings at a cost of $40,000.00 and it is estimated that these will last four years. A Sinking Fund is established by setting aside at the end of each year an amount that will, with interest accumulations at 4 per cent., compounded annually, provide $40,000.00 at the end of four years.

Make the necessary entries and show the accounts for Sinking Fund Reserve and Sinking Fund Investment. The annual amount required is $9,419.60. Assume that the rate earned is 4 per cent. as estimated.

Solution—

NOTE. In order that the entries may be followed easily in their sequence, the cash entries are illustrated in journal form. The term Profit and Loss refers to the operating accounts as a whole. It would be proper to charge Depreciation Account when setting up the reserve and close Depreciation Account to operations but, in the interests of brevity, the illustration shows the charge made direct to Profit and Loss.

End of 1st year.	Profit and Loss	$9,419.60	
	To Sinking Fund Reserve		$9,419.60
	Provision for Depreciation on Sinking Fund plan.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
	Cash paid over to Sinking Fund.		
End of 2nd year.	Sinking Fund Investment	376.80	
	To Sinking Fund Reserve		376.80
	Interest earned, added to Investment and to Reserve.		
	Profit and Loss	9,419.60	
	To Sinking Fund Reserve		9,419.60
	Provision for Depreciation.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
End of 3rd year.	Sinking Fund Investment	768.64	
	To Sinking Fund Reserve		768.64
	Interest addition.		
	Profit and Loss	9,419.60	
	To Sinking Fund Reserve		9,419.60
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
End of 4th year.	Sinking Fund Investment	1,176.16	
	To Sinking Fund Reserve		1,176.16
	Interest addition.		
	Profit and Loss	9,419.60	
	To Sinking Fund Reserve		9,419.60
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60

Assuming that the fund is used for the purpose intended, there will be entries made to record the realization of the investment, to write off the old asset and to record the acquisition of the new.

Cash	$40,000.00	
To Sinking Fund Investment		$40,000.00
Funds withdrawn from Investment.		
Sinking Fund Reserve	40,000.00	
To Buildings		40,000.00
To apply the reserve covering depreciation to write off the asset.		
Buildings	40,000.00	
To Cash		40,000.00
Replacement of old buildings by new.		

LEDGER ACCOUNTS

Dr. *Buildings* *Cr.*

When acquired, Cost			$40,000.00	End 4th year Sinking Fund (Dep'n.) Reserve			$40,000.00
End 4th year, Applied to replacement	C.	–	$40,000.00				

Dr. *Sinking Fund Reserve* *Cr.*

End 4th year Buildings	J.	–	$40,000.00	End 1st year Profit and Loss	J.	–	$9,419.60
				End 2nd year Interest	J.	–	376.80
				Profit and Loss	J.	–	9,419.60
				End 3rd year Interest	J.	–	768.64
				Profit and Loss	J.	–	9,419.60
				End 4th year Interest	J.	–	1,176.16
				Profit and Loss	J.	–	9,419.60
			$40,000.00				$40,000.00

Dr. *Sinking Fund Investment* *Cr.*

End 1st year	C.	–	$9,419.60	End 4th year Amount realized	C.	–	$40,000.00
,, 2nd year Interest	J.	–	376.80				
,, ,,	C.	–	9,419.60				
,, 3rd year Interest	J.	–	768.64				
,, ,,	C.	–	9,419.60				
,, 4th year Interest	J.	–	1,176.16				
,, ,,	C.	–	9,419.60				
			$40,000.00				$40,000.00

The asset first acquired has been written off by applying against it the Sinking Fund (Depreciation) Reserve.

The investment has been realized and brought in and the amount then applied to the replacement of the asset.

The question may arise as to whether the interest on the Sinking Fund should not appear as income, and thus be first credited to an account for Interest Earned on Sinking Fund, which in turn would be closed to Profit and Loss.

Under this plan, if that were followed, the charge to operations for depreciation would need to be increased by the amounts of interest in order to keep the reserve up to requirements. The result then would be that if the interest is shown as income there is a correspondingly greater charge on the other side, so that the net income is the same whichever plan is followed. Either would be correct.

The interest belongs absolutely to the Sinking Fund, and so the method more easily followed has been applied.

A difference on this point will arise when Sinking Funds for the repayment of a debt are being dealt with and should be studied very closely.

Sinking Fund for Redemption of Debt

A Sinking Fund may be built up for any express purpose, but that of redemption of funded debt is the most common.

The process may be very simple and the accounting features equally so, if nothing is done but pay over to the fund annually the amount required and add the interest accumulations. The account for the investment would show how much is accumulated at any time.

As the subject is being considered from the point of view of business corporations, some disadvantages that may arise, if an account for the investment only is kept, are noted.

It should be first observed that while, when the purpose of a Sinking Fund was to provide for the replacement of a depreciating asset, the amount taken out was equivalent to a charge made to operations for depreciation, the element of expense or loss does not enter in when the purpose is to provide for the payment of a debt. The actual payment of a debt, or the provision for it, does not involve any charge to operations. It involves payments but not expenditure.

Assuming that the money borrowed has been used to acquire a fixed asset, the question naturally arises as to the source from which the funds will be obtained to build up the Sinking Fund to repay the debt incurred when the funds were obtained to acquire the asset.

Suppose that a corporation has a profit of $50,000.00 and it is under obligation to pay over to the Sinking Fund $7,500.00 a year. If it applied

all its profits to dividends it is obvious, leaving out of consideration any other influences on working capital, that it has taken out what has been added through profit earning and to take out a further $7,500.00 would mean that the working capital is being drawn on and possibly reduced below the amount at which it stood at the beginning of the year.

As a protection to the working capital position it is desirable that profits equal to the amount paid out for Sinking Fund be held back from distribution so that when the payment is made to the Sinking Fund it is out of assets that have been added through earnings.

Should reserve funds (or general reserves) be built up to an amount equivalent to what is being taken out in this way, the purpose would be served, but there would be nothing to earmark such amounts and they may be drawn on in less prosperous years for other purposes. There is the further fact that there would not be, in the accounts, a definite check on the investment that would tell whether or not it is being kept up to requirements. This makes it desirable that a Sinking Fund reserve be created and carried at the amount at which the investment ought to stand. This is done by an appropriation out of net profits for the amount required, which draws attention to the vital fact that, when the purpose is to provide for the repayment of a debt, a Sinking Fund Reserve is set up by an appropriation out of net profits and not by a charge to operations.

There is another important distinction. When the purpose of a Sinking Fund was to provide for the replacement of an asset and represent the investments of the amount realized from providing for depreciation, it was found that final results were not affected at all by merely adding the interest accumulations to the investment and to the Sinking Fund Reserve because if the interest were shown as revenue, there would be a correspondingly greater charge to Revenue. When the purpose is to provide for the payment of a debt and the question of charges to revenue does not enter in, it is necessary, in order to show the true earnings from all sources, to record the interest earned on the Sinking Fund as revenue. It would be liable for Income Tax and should not be concealed. This necessitates making the appropriation in each period after the first for the amount of the annual requirement plus the interest accumulation.

When the annual requirement is determined, it is assumed that the investment fund will earn a certain rate of interest. Unless the amounts are deposited with a trust company at a guaranteed rate, or dealt with in some other similar manner, it is unlikely that the rate earned will agree exactly with that estimated. The examples that follow will, in order, illustrate the working of the fund when it earns the exact rate estimated, when it earns more, and when it earns less.

Interest Earned at Rate Estimated.

Problem. A Limited Company issued $40,000.00 of 4-year $5\frac{1}{2}$ per cent. bonds and is obligated to create a Sinking Fund sufficient for their retirement

when due. The Sinking Fund, it is estimated, will earn 4 per cent. compounded yearly, and the amount to be set aside in the fund each year is $9,419.60.

Make the necessary entries and show the accounts affected.

Solution. The interest at 5½ per cent. on the bonds does not enter into the problem, as it is paid each year (or half-year as the case may be) and charged to the current Profit and Loss Account, after operating profit but before net profit.

NOTE. The cash entries are illustrated in journal form for convenience in following the transactions in their order.

When the funds are borrowed, a cash book entry records the receipt and posting is made to the credit of an account for Bonds Payable.

Entries—

End of 1st year.	Profit and Loss Appropriation To Sinking Fund Reserve To reserve from distribution profits equal to the amount required for Sinking Fund.	$9,419.60	$9,419.60
	Sinking Fund Investment To Cash Payment over of amount required for Sinking Fund.	9,419.60	9,419.60
End of 2nd year.	Sinking Fund Investment To Interest Earned by Sinking Fund Investment increased by 4% on $9,419.60.	376.80	376.80
	Profit and Loss Appropriation To Sinking Fund Reserve To appropriate to Sinking Fund the annual instalment $9,419.60 + interest earned $376.80.	9,796.40	9,796.40
	Sinking Fund Investment To Cash Payment of annual instalment.	9,419.60	9,419.60
End of 3rd year.	Sinking Fund Investment To Interest Earned by Sinking Fund To record interest earned.	768.64	768.64
	Profit and Loss Appropriation To Sinking Fund Reserve To appropriate annual instalment $9,419.60 + interest earned, $768.64 to Sinking Fund.	10,188.24	10,188.24
	Sinking Fund Investment To Cash Payment of annual instalment.	9,419.60	9,419.60

End of 4th year.	Sinking Fund Investment	$1,176.16	
	To Interest Earned by Sinking Fund		$1,176.16
	Interest earned.		
	Profit and Loss Appropriation	10,595.76	
	To Sinking Fund Reserve		10,595.76
	To appropriate amount of annual instalment plus interest earned.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60

The amount required has been accumulated and the next entries will record the realization and drawing in of the investment and the payment of the debt.

Cash	$40,000.00	
To Sinking Fund Investment		$40,000.00
Bonds Payable	40,000.00	
To Cash		40,000.00
Payment of the Debt.		

If the amount of the debt is paid out of the Sinking Fund without the funds being first withdrawn, the settlement may have been recorded by one entry—

Bonds Payable	$40,000.00	
To Sinking Fund Investment		$40,000.00

The Sinking Fund Reserve has not been affected by the settlement and closing out of the investment and bonds payable and so remains intact.

It indicates only that an amount of earned surplus has been earmarked and held back from being available for distribution while the Sinking Fund was being built up. Now, with that purpose accomplished, the amount of the Sinking Fund Reserve may be set free again and this is recorded by the entry—

Sinking Fund Reserve	$40,000.00	
To Reserve Fund		$40,000.00

The transfer could have been to the credit of the Appropriation Account, but it is fair to assume it will not be used at once but continue to be reserved.

Sinking Fund Reserve Still Represented by Assets. That the amount of the Sinking Fund Reserve, now made available for appropriation for dividends or other purposes, is still represented by assets may not at once be apparent if the idea is conveyed only that, as net profits were transferred to the reserve, the money was taken out and so the debt was paid out of earnings. It must be remembered, however, that if the debt has been paid out of earnings, there still remains within the business the value received when the money was borrowed. The reserve is still represented by assets and could not appear as part of the shareholders' equity if otherwise. Stating

it in another way, there was $40,000.00 received when the bonds were issued and a further $40,000.00 was retained out of earnings, while only $40,000.00 has been paid out to pay off the debt, so that $40,000.00 still remains.

LEDGER ACCOUNTS

Dr. *Sinking Fund Investment* *Cr.*

End 1st year			End 4th year			
Annual payment C.	–	$9,419.60	Realization C.			$40,000.00
End 2nd year						
Interest earned J.	–	376.80				
Annual payment C.	–	9,419.60				
End 3rd year						
Interest earned J.	–	768.64				
Annual payment C.	–	9,419.60				
End 4th year						
Interest earned J.	–	1,176.16				
Annual payment C.	–	9,419.60				
		$40,000.00				$40,000.00

Dr. *Sinking Fund Reserve* *Cr.*

End 4th year			End 1st year		
To Reserve Fund J.	–	$40,000.00	Appropriation J.	–	$9,419.60
			End 2nd year		
			Appropriation J.	–	9,796.40
			End 3rd year		
			Appropriation J.	–	10,188.24
			End 4th year		
			Appropriation J.	–	10,005.76
		$40,000.00			$40,000.00

Dr. *Reserve Fund* *Cr.*

			End 4th year		
			Transfer S. F.		
			Reserve J.	–	$40,000.00

Dr. *Bonds Payable* *Cr.*

End 4th year C.	–	$40,000.00	At issue C.	–	$40,000.00

The account for "Interest Earned by Sinking Fund" is closed each year to the credit of Profit and Loss before net profit is determined.

Interest Earning Higher than Estimated. It is seldom that, unless the funds are placed with a trust company at a guaranteed rate of interest, the earnings by a Sinking Fund will be at the exact rate estimated. When the amount earned is either more or less than estimated it is desirable to keep

the Sinking Fund Reserve at the amount estimated, i.e. at the amount required on the basis of the original calculation, and show the difference as Sinking Fund Surplus or Deficit. From this method the accounts indicate the exact position of the fund in relation to requirements. The Sinking Fund Reserve Account shows the amount that should be in the investment fund, the Investment Account shows how much there actually is, while the account for Surplus or Deficit indicates the amount above or below requirements.

Problem. A corporation issued $40,000.00 of 4-year 5½ per cent. Sinking Fund Bonds. A Sinking Fund is created by setting aside, at the end of each year, $9,419.60 which, accumulating at 4 per cent. interest, compounded annually, will provide the $40,000.00 required at the end of the fourth year. It is found that the rate actually earned by the Sinking Fund is 5 per cent. compounded yearly. Make entries necessary and accounts for the Sinking Fund.

Solution. At the time the bonds were issued a cash receipt would be recorded and posted to the credit of the account for bonds payable as shown in the ledger account.

End of 1st year.	Profit and Loss Appropriation	$9,419.60	
	To Sinking Fund Reserve		$9,419.60
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
End of 2nd year.	Sinking Fund Investment	470.98	
	To Interest Earned on Sinking Fund		470,98
	Interest earned—5% on $9,419.60.		
	Profit and Loss Appropriation	9,890.58	
	To Sinking Fund Reserve		9,796.40
	,, Sinking Fund Surplus		94.18
	To appropriate to S.F. Reserve the annual provision $9,419.60 + interest at estimated rate, 4%, and credit S.F. Surplus with excess interest earned.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
	Annual contribution.		
End of 3rd year.	Sinking Fund Investment	965.51	
	To Interest Earned by Sinking Fund		965.51
	Earned 5% on $19,310.18.		
	Profit and Loss Appropriation	10,385.11	
	To Sinking Fund Reserve		10,188.24
	,, Sinking Fund Surplus		196.87
	To appropriate to S.F. Reserve $9,419.60 + interest $768.64 (4% on $19,216.00) and credit S.F. Surplus with excess interest earned.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
	Annual contribution.		

End of 4th year.	Sinking Fund Investment To Interest Earned on Sinking Fund	$1,484.76	$1,484.76
	Earned 5% on $29,695.29.		
	Profit and Loss Appropriation To Sinking Fund Reserve ,, Sinking Fund Surplus	10,904.36	10,595.76 308.60
	To appropriate to S.F. Reserve $9,419.60 and interest on credit in Reserve at 4% and credit S.F. surplus with excess interest.		
	Sinking Fund Investment To Cash	8,819.95	8,819.95
	Annual contribution $9,419.60 less Surplus through excess earnings $599.65.		
	Cash To Sinking Fund Investment	40,000.00	40,000.00
	Bonds Payable To Cash	40,000.00	40,000.00
	Sinking Fund Reserve Sinking Fund Surplus To Reserve Fund	40,000.00 599.65	40,599.65

LEDGER ACCOUNTS

The accounts relating to the bonds and Sinking Fund only are shown. The interest earned by the Sinking Fund would be posted to an account under the title as indicated in the Journal entries, and this account closed each year to the credit of Profit and Loss before net profit.

Dr. *Sinking Fund Investment* *Cr.*

End 1st year				End 2nd year			
Annual contbn.	C.	–	$9,419.60	Balance			$19,310.18
End 2nd year							
Interest earned	J.	–	470.98				
Annual contbn.	C.	–	9,419.60				
			$19,310.18				$19,310.18
3rd year Balance			$19,310.18	End 3rd year			
End 3rd year				Balance			$29,695.29
Interest earned	J.		965,51				
Annual contbn.	C.	–	9,419.60				
			$29,695.29				$29,695.29
4th year Balance			$29,695.29	End 4th year			
End 4th year				Realization	C.	–	$40,000.00
Interest earned	J.	–	1,484.76				
Contributions	C.	–	8,819.95				
			$40,000.00				$40,000.00

Dr. *Sinking Fund Reserve* *Cr.*

End 2nd year Balance			$19,216.00	End 1st year Appropriation	J.	–	$9,419.60
				End 2nd year Appropriation	J.		9,796.40
			$19,216.00				$19,216.00
End 3rd year Balance			$29,404.24	3rd year Balance			$19,216.00
				End 3rd year Appropriation	J.	–	10,188.24
			$29,404.24				$29,404.24
End 4th year Transfer to Reserve Fund	J.	–	$40,000.00	4th year Balance			$29,404.24
				End 4th year Appropriation	J.	–	10,595.76
			$40,000.00				$40,000.00

Dr. *Sinking Fund Surplus* *Cr.*

End 4th year Transfer to Reserve Fund	J.	–	$599.65	End 2nd year Excess earning	J.	–	$ 94.18
				End 3rd year Excess earning	J.	–	196.87
				End 4th year Excess earning	J.	–	308.60
			$599.65				$599.65

Dr. *Reserve Fund* *Cr.*

				End 4th year Transfer S.F. Reserve	J	–	$40,000.00
				Transfer S.F. Surplus	J.	–	599.65

Dr. *Bonds Payable* *Cr.*

End 4th year	J.	–	$40,000.00	At Issue	C.	–	$40,000.00

Little difficulty will be found in preparing for the annual entries if it is kept in mind that the amount actually earned has been calculated on the balance in the Investment account while the estimated rate of 4 per cent. has been applied to the balance in the Sinking Fund Reserve, which has been kept up on the basis of requirements. The difference between the amounts arrived at from these calculations is the excess earning to be treated as Sinking Fund Surplus.

With the accounts in this form, a separate Sinking Fund Balance Sheet, showing the position of the fund, is easily possible. At the end of the third year this is—

Sinking Fund Balance Sheet

Sinking Fund Investment	$29,695.29	Sinking Fund Reserve	$29,404.24
		Sinking Fund Surplus	291.05
	$29,695.29		$29,695.29

Interest Earning Lower than Estimated. Should the interest earned by the fund be less than estimated, with the result that the fund stands at less than requirements, it is desirable that the accounts reveal the exact situation. This can be done by keeping the reserve up to requirements with the offsetting deficit in a separate account. The earnings would not likely work out to an even percentage but an even rate is used in the example to illustrate the feature.

Problem. A corporation issued $40,000.00 of 5½ per cent. 4-year bonds and a Sinking Fund was created to retire the issue at maturity. The estimated rate of interest accumulation is 4 per cent. compounded yearly, and on this basis the annual payment into the fund is $9,419.60. The rate actually earned is 3 per cent.

Make the entries relating to the Sinking Fund and show the accounts.

Solution. Entries are all shown in journal form, to preserve the order.

End 1st year.	Profit and Loss Appropriation	$9,419.60	
	To Sinking Fund Reserve		$9,419.60
	Annual instalment appropriation.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
End 2nd year.	Sinking Fund Investment	282.59	
	To Interest Earned on Sinking Fund		282.59
	Interest earned—3% on $9,419.60.		
	Profit and Loss Appropriation	9,702.19	
	Sinking Fund Deficit	94.21	
	To Sinking Fund Reserve		9,796.40
	To appropriate annual instalment + actual interest earned, $9,419.60 + $282.59, and credit Reserve with annual instalment plus estimated interest 4%, $9,419.60 + $376.80 and charge the difference between estimated and actual interest to Deficit account.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
	Payment of annual instalment.		

End 3rd year.	Sinking Fund Investment	$573.65	
	To Interest Earned by Sinking Fund		$573.65
	Interest earned—3% on $19,121.79.		
	Profit and Loss Appropriation	9,993.25	
	Sinking Fund Deficit	194.99	
	To Sinking Fund Reserve		10,188.24
	To appropriate $9,419.60 + $573.65, credit Reserve with $9,419.60 + $768.64 and record difference as deficit.		
	Sinking Fund Investment	9,419.60	
	To Cash		9,419.60
End 4th year.	Sinking Fund Investment	873.45	
	To Interest Earned by Sinking Fund		873.45
	3% on $29,115.04.		
	Profit and Loss Appropriation	10,293.05	
	Sinking Fund Deficit	302.71	
	To Sinking Fund Reserve		10,595.76
	To appropriate $9,419.60 + 3% on $29,115.04 or $873.45, credit Reserve with $9,419.60 + 4% on $29,404.24 or $1,176.16, and record difference as deficit.		
	Sinking Fund Reserve	591.91	
	To Sinking Fund Deficit		591.91
	To close Deficit account.		
	Sinking Fund Investment	591.91	
	To Cash		591.91
	To pay into fund the amount required to complete.		
	Cash	40,000.00	
	To Sinking Fund Investment		40,000.00
	Bonds Payable	40,000.00	
	To Cash		40,000.00
	Sinking Fund Reserve	39,408.09	
	To Reserve Fund		39,408.09

An alternative entry to write off the deficit would be—

Profit and Loss Appropriation	591.91	
To Sinking Fund Deficit		591.91

after which the Sinking Fund Reserve would be closed out at $40,000.00 to Reserve Fund. This indicates a further appropriation to cover the deficit.

As the fund is realized at the same time as the last instalment to it is due, it may appear unnecessary to record the last payment into the fund. To make the entries, however, recognizes that the last instalment is used for Sinking Fund purposes and is part of the fund. It also indicates by the account that the fund is complete.

The interest earned in each year is calculated on the balance in the Investment Account. In practice this would not be the case unless the fund

were deposited at a stated rate. In any event, however, it is on the amount in the investment that the interest is earned.

The estimated interest, i.e. the amount on the basis of requirements, is calculated at the stated rate (in this case 4 per cent) on the amount at the credit of the Reserve, i.e. on the amount that, on the basis of requirements, should be in the fund. The deficit for each year is the excess of the latter over the former, i.e. the excess of estimated over actual.

By adopting this method a Sinking Fund Balance Sheet, apart from other accounts, may be prepared at any time and the real position of the fund portrayed.

LEDGER ACCOUNTS

Dr. *Sinking Fund Investment* *Cr.*

End 1st year				End 2nd year			
Annual instalment	C.	–	$9,419.60	Balance			$19,121.79
End 2nd year							
Interest	J.	–	282.59				
Annual instalment	C.	–	9,419.60				
			$19,121.79				$19,121.79
3rd year Balance			$19,121.79	End 3rd year			
End 3rd year				Balance			$29,115.04
Interest	J.	–	573.65				
Annual instalment	C.	–	$9,419.60				
			$29,115.04				$29,115.04
4th year Balance			$29,115.04	End 4th year			
End 4th year				Realization	C.	–	$40,000.00
Interest	J.	–	873.45				
Annual instalment	C.	–	9,419.60				
Special contributn.	C.	–	591.91				
			$40,000.00				$40,000.00

Dr. *Sinking Fund Reserve* *Cr.*

End 2nd year				End 1st year			
Balance			$19,216.00	Appropriation	J.	–	$9,419.60
				End 2nd year			
				Appropriation, etc.	J.	–	9,796.40
			$19,216.00				$19,216.00
End 3rd year				3rd year			
Balance			$29,404.24	Balance			$19,216.00
				End 3rd year			
				Appropriation	J.	–	10,188.24
			$29,404.24				$29,404.24
End 4th year				4th year			
Deficit	J.	–	$591.91	Balance			$29,404.24
Transfer to Reserve Fund	J.	–	39,408.09	End 4th year			
				Appropriation	J.	–	10,595.76
			$40,000.00				$40,000.00

Dr.			Sinking Fund Surplus or Deficit		Cr.
End 2nd year Deficit	J.	–	$94.21	End 3rd year Balance			$289.20
End 3rd year Deficit	J.	–	194.99				
			$289.20				$289.20
4th year Balance			$289.20	End 4th year By Sinking Fund Reserve	J.	–	$591.91
End 4th year Deficit	J.	–	302.71				
			$591.91				$591.91

Sinking Fund Balance Sheets

The first illustration that follows shows the position of the Sinking Fund at the end of the third year, when a surplus exists.

Sinking Fund Balance Sheet

At the End of the Third Year

Assets	
Sinking Fund Investment Cash and Securities	$29,695.29
	$29,695.29
Requirements and Surplus	
Sinking Fund Reserve	$29,404.24
Sinking Fund Surplus	291.05
	$29,695.29

There follows a similar Balance Sheet at the same date, but showing the position when the fund earns less than estimated.

Sinking Fund Balance Sheet

At the end of the Third Year

Assets and Deficit	
Investment—Cash and Securities	$29,115.04
Sinking Fund Deficit	289.20
	$29,404.24
Requirements	
Sinking Fund Reserve	$29,404.24
	$29,404.24

Or:

Assets		
Investment—Cash and Securities		$29,115.04
		$29,115.04
Requirements and Deficit		
Sinking Fund Reserve	$29,404.24	
Deduct Deficit	289.20	$29,115.04
		$29,115.04

Provision if no Profits

Appropriations naturally assume that there are net profits from which to make them, and it would be expected that when a corporation has bonds outstanding and it is required to provide a Sinking Fund to meet the principal when due, there will be profits sufficient that the amount required for Sinking Fund each year may be withheld from distribution.

Experience in a period of depression draws attention to the fact that a company may lack profits in any particular year. If there is a reserve accumulated, the amount would be transferred back to the Appropriation Account and then appropriated to the Sinking Fund Reserve. The only difference that such entry makes is that that particular reserve is kept up to requirements as a check on the fund. Since there has been no addition to the assets through earnings, it is not a case of holding back a part of the addition, but rather earmarking a part that had been added in previous years.

Suppose, however, that the payment of interest on the bonds has created a deficit, which in turn has required accumulated reserves to be transferred in order to cover the deficit, as far as possible, thus leaving no surplus of any kind aside from the amount already in the Sinking Fund Reserve. The question arises as to what entries would be made for the annual provision.

It is desirable, as already pointed out, that the Sinking Fund Reserve be kept at requirements, although such a reserve is not an inherent necessity of building up the investment but serves special purposes already outlined. Rather than omit the annual entry and thus lose the relation between requirements and the actual Sinking Fund Investment, in the accounts, it would seem desirable that an entry be made even though there is nothing to appropriate. This might be—

Annual Sinking Fund Requirement
To Sinking Fund Reserve

The above entry would be for the amount of the annual instalment and, of course, the interest accumulated during the past year, which is definitely connected with the fund and must be always included in it.

The account "Annual Sinking Fund Requirement" merely increases the deficit but is offset by the amount added to the Sinking Fund Reserve so that, as far as the shareholders' equity is concerned, there is no change. Their equity consists of the Paid-up Capital + Sinking Fund Reserve – Deficit – Annual Sinking Fund Requirement.

The Net Surplus or Deficit is represented by the difference between the Sinking Fund Reserve and the two minus accounts to which reference has been made.

The same result would be obtained by charging the Appropriation Account in which the deficit already appears, but it does not seem logical to show an appropriation when there is nothing to appropriate.

Investment in Corporation's Own Bonds

A trust deed may provide that the money transferred for Sinking Fund purposes must be used in the purchase of the corporation's own bonds. If they are purchased and held, as any other securities would be, the financial books are not affected in any way, nor is the amount of bonds outstanding. The corporation will continue to pay interest on the bonds, the money going to the Sinking Fund.

The same will be true if the bonds purchased by the Sinking Fund are those bonds that the fund is being provided to meet, if these have been purchased on the open market or drawn by lot and are to be held as investments.

A different provision, however, is sometimes made.

Bonds Purchased and Cancelled. It is sometimes provided that bonds purchased by Sinking Fund, instead of being held as an investment until due, are to be cancelled. This reduces immediately the amount of bonds outstanding, and also reduces the Sinking Fund Investment.

If the bonds are bought at par by the trustee and cancelled, this part is covered by the entry—

Bonds
  To Sinking Fund Investment.

Usually, however, they would be purchased at a discount or premium.

Suppose the trustee bought $10,000.00 of the outstanding bonds at 95. The entry for the financial books will be expressed as—

Bonds Payable	$10,000.00	
To Sinking Fund Investment		$9,500.00
,, Profit and Loss on Bonds Redeemed		500.00

Had he purchased the same bonds at 105, the entry would be—

Bonds Payable	$10,000.00	
Profit and Loss on Bonds Redeemed	500.00	
(or Bond Redemption Reserve)		
To Sinking Fund Investment		$10,500.00

This would appear to shut off the interest earning but this would be avoided usually by the provision that the annual amount paid over to the Sinking Fund must be increased by the amount of interest on the bonds that have been cancelled. This is not an interest charge but an addition to the appropriation.

In a case such as this, where the investment is kept at a minimum, it may be satisfactory to omit the Sinking Fund Reserve altogether as, if the appropriations are made, the entry can be reversed when the investment is reduced by the purchase and cancellation of the bonds.

Accounts of Trustee

Assuming that the Sinking Fund of a corporation is held and managed by a trustee, it is apparent that any cash and securities in his hands on that account are held in trust. Whenever trust assets are held there is a corresponding liability to the party for whom they are held. When the trustee receives amounts from the corporation the entry may be illustrated as—

X Corporation Sinking Fund Cash
    To X Corporation Sinking Fund.

When interest falls due it will be received by the trustee and recorded by a similar entry.

When securities are purchased, the transaction may be expressed by the entry—

X Corporation Sinking Fund Securities
    To X Corporation Sinking Fund Cash.

Should the trustee purchase the bonds against which the Sinking Fund is being built up and the bonds are cancelled, the liability to the corporation is reduced, since the securities have been cancelled. If, at the time of purchase, he makes the entry as above, this will be followed at cancellation by a further entry—

X Corporation Sinking Fund
    To X Corporation Sinking Fund Securities.

The amount of cash and securities in the hands of the trustee will always equal the liability for the amount held in trust. If a separate set of accounts is kept for each Sinking Fund, it will not be necessary in this particular account to name the corporation in connection with each of the above entries, but for the purpose of illustration this is included.

CHAPTER FOURTEEN

MANUFACTURING ACCOUNTS FINANCIAL STATEMENTS

AFTER a review of a number of features peculiar to Limited Companies, it will be apparent that the Operating Accounts and Financial Statements may be more involved than those already used for illustrative purposes.

The illustration already given referred to a purely trading company. A very large number of Limited Companies, however, produce the bulk of the goods they sell, which may introduce another section to the Operating Account. This is known as the Manufacturing Account.

While illustrating this feature, other points that have been dealt with already are included in the same example, which will thus serve to some extent as a summary of subjects already covered.

Manufacturing Account. In the example that is being taken it will be observed that all the accounts recording elements of cost have been built up in the General Ledger, so that at the end of the period it is possible, by transferring these to a Manufacturing Account, to arrive at the cost of goods manufactured during the period. Under some systems, the relation between the General books and the Cost records is such that a Manufacturing Account cannot be built up in the Ledger. This is due to the fact that, under some methods, the accounts for the elements of cost are kept in a separate ledger, with only a Controlling Account for the Factory in the General Ledger while, in others, the accounts for the elements of cost are closed to Work in Process, as reports are received from the Factory of charges to the various orders or processes. It is assumed, then, in this case, where the Manufacturing Account is shown in the General Ledger of the business, that the Cost records are entirely separated from the General books.

Only those items that enter into the cost of production will be transferred to the Manufacturing Account. It should be observed that any cost connected with the factory operation constitutes a part of the cost of production. There may be overhead charges that can be made direct to a department while others are so general in their character that they must be spread over all departments, but the question to determine is whether the term General Oncost relates to the Factory or does not.

Selling costs do not constitute costs of production. The general administration or financing of the business, also, is separate entirely from the cost of production, although a portion of such charges, if they benefit the factory,

may be charged in the production costs. This emphasizes the point to which reference has already been made, that is, it is the nature and relation of an item and not its name that determines its place in the operating accounts.

Problem. From the information that follows, prepare Manufacturing, Trading, Profit and Loss and Appropriation Accounts, and Balance Sheet of the Illustrative Company, Ltd., as at December 31, 19—.

Trial Balance

December 31, 19—

Debit Balances

Cash in Bank	$12,000.00
Bills Receivable	32,000.00
Accounts Receivable	30,000.00
Stock Inventories—	
Jan. 1, 19—(beginning of period)	
Finished Goods	24,000.00
Work in Process	18,000.00
Raw Material	45,000.00
Purchases—Raw Material	190,000.00
Purchases—Finished Goods	4,000.00
Freight and Duty—	
Raw Material	15,000.00
Finished Goods	300.00
Returned Sales	400.00
Freight on Sales	300.00
Wages—Direct	60,000.00
Wages—Indirect	8,000.00
Taxes—Factory	1,800.00
Taxes—General Office	200.00
Insurance—Factory	800.00
Insurance—Office	100.00
Factory Expense	12,000.00
Salaries—Factory	10,000.00
Salaries—Office	10,000.00
Office Expenses	4,000.00
Salesmen's Salaries	8,000.00
Salesmen's Expenses	6,000.00
Advertising	2,500.00
Land	20,000.00
Buildings—Factory	80,000.00
Buildings—Office	6,000.00
Plant and Machinery	160,000.00
Office Equipment	4,000.00
Patents	20,000.00
Organization Expense	5,000.00
Bond Interest	6,000.00
Bond Discount	2,000.00
Cash Discounts	4,000.00
Subscribers—(Preferred) Calls Unpaid	6,000.00
Sinking Fund Investment	53,200.00
Bank Interest	4,000.00
Goodwill	20,000.00
	$884,600.00

Continued on next page

Credit Balances

Accounts Payable	$12,000.00
Bills Payable	10,000.00
Bank Loans	50,000.00
Bonds 6%	140,000.00
Returned Purchases (R.M.)	200.00
Sales	380,000.00
Cash Discounts	1,800.00
Reserve for Bad Debts	1,000.00
Sales Tax	300.00
Reserves for Depreciation—	
Buildings—Factory	4,000.00
Buildings—Office	400.00
Plant and Machinery	32,000.00
Office Equipment	1,000.00
Capital Stock—Subscribed	
7% Preferred	100,000.00
Common—2,000 Shares without par value	50,000.00
Reserve Fund	30,000.00
Sinking Fund Reserve	50,000.00
Sinking Fund Surplus	1,000.00
Interest Earned on Sinking Fund	2,200.00
Unappropriated Profits	8,700.00
Capital Surplus	10,000.00
	$884,600.00

Inventories December 31, 19— (end of period) were: Finished Goods, $28,000.00, Work in Process, $20,000.00, Raw Material, $50,000.00.

Wages unpaid—Direct $1,000.00.

Insurance Unexpired—Factory $100.00.

Provide for 2½ per cent. Depreciation in Buildings and 10 per cent. in Plant and Machinery, Office Equipment and Patents. Patents cover manufacturing rights.

Add sufficient to the Reserve for Bad Debts to bring it up to 3 per cent. of Accounts and Bills Receivable.

Write $200.00 off from Bond Discount. The bonds were outstanding during the whole period.

Appropriate $4,000.00 to Sinking Fund Reserve for the annual instalment and also make proper appropriation of the amount of interest earned on the Sinking Fund Investment.

The estimated interest on the Sinking Fund was $2,000.00, i.e. on the basis of requirements. The difference between the amount in the investment and the amount at the credit of Sinking Fund Reserve and Sinking Fund Surplus is accounted for by the interest earned, which was charged to the

investment when credit was made to the account for interest earned. The amount due to the Sinking Fund Investment for the annual instalment will be paid early in the next year.

Provide for the annual preferred dividend (on the Par Value) and for a dividend of $1.50 a share on the common. These are declared and are payable in January next.

Write off the Organization Expense by the method you consider to be proper.

Provide for Dominion Income Tax. This will be paid in April next.

Transfer $8,000.00 to the Reserve Fund.

Of the Bank Interest, $300.00 was on short term or temporary loans, and the balance represents interest on loans that remained fairly constant throughout the year, and so may be treated in the same manner as interest on other long term loans.

Solution.

Journal

19—		*Dr.*	*Cr.*
Dec. 31.	Manufacturing Account	$268,000.00	
	To Work in Process (Jan. 1)		$18,000.00
	,, Raw Material (Jan. 1)		45,000.00
	,, Raw Material Purchases		190,000.00
	,, Freight and Duty—Raw Material		15,000.00
	Manufacturing Account	61,000.00	
	To Wages—Direct		61,000.00
	Manufacturing Account	52,500.00	
	To Wages—Indirect		8,000.00
	,, Taxes—Factory		1,800.00
	,, Insurance—Factory		700.00
	,, Factory Expense		12,000.00
	,, Salaries—Factory		10,000.00
	,, Depreciation—Factory Buildings		2,000.00
	,, Depreciation—Plant and Machinery		16,000.00
	,, Patents—Amount written off		2,000.00
	Returned Purchases	200.00	
	To Purchases—Raw Material		200.00
	Raw Material—Inventory, Dec. 31	50,000.00	
	Work in Process—Dec. 31	20,000.00	
	To Manufacturing Account		70,000.00
	The above entries bring the charges and credits into the Manufacturing Account.		
	Trading Account	24,000.00	
	To Finished Goods—Inventory, Jan. 1		24,000.00

Journal—(contd.)

19—		*Dr.*	*Cr.*
Dec. 31.	Trading Account	$311,300.00	
	To Manufacturing Account		$311,300.00
	To transfer cost of goods finished to the Trading Account		
	Trading Account	4,300.00	
	To Purchases—Finished Goods		4,000.00
	,, Freight and Duty—Finished Goods		300.00
	Sales	400.00	
	To Returned Sales		400.00
	Sales	379,600.00	
	To Trading Account		379,600.00
	Finished Goods—Inventory	28,000.00	
	To Trading Account		28,000.00
	Profit and Loss	16,800.00	
	To Salesmen's Salaries		8,000.00
	,, Salesmen's Expenses		6,000.00
	,, Advertising		2,500.00
	,, Freight on Sales		300.00
	Transferring Selling Expenses to Profit and Loss		
	Profit and Loss	14,850.00	
	To Salaries—Office		10,000.00
	,, Office Expenses		4,000.00
	,, Insurance—Office		100.00
	,, Taxes—Office		200.00
	,, Depreciation—Office Building		150.00
	,, Depreciation—Office Equipment		400.00
	Administration Costs.		
	Profit and Loss	5,160.00	
	To Provision for Bad Debts (Reserve)		860.00
	,, Bank Interest—Temporary Loans		300.00
	,, Cash Discounts Allowed		4,000.00
	Incidental Financial Expenses.		
	Cash Discounts Earned	1,800.00	
	To Profit and Loss		1,800.00
	Interest Earned on Sinking Fund	2,200.00	
	To Profit and Loss		2,200.00
	Profit and Loss	12,300.00	
	To Bank Interest		3,700.00
	,, Interest on Bonds		8,400.00
	,, Discount on Bonds		200.00
	To charge interest on Bank Loans that remain more or less constant and interest on long term loans (Bonds) including proportion of discount on bonds which adjusts to the effective interest charge.		
	Profit and Loss	22,890.00	
	To Profit and Loss Appropriation		22,890.00
	Transfer of Net Profits to Appropriation Account.		

Journal—(contd.)

		Dr.	*Cr.*
19—			
Dec. 31.	Profit and Loss Appropriation	$25,887.20	
	To Dominion Income Tax		$1,687.20
	,, Sinking Fund Reserve		6,000.00
	,, Sinking Fund Surplus		200.00
	,, Dividend—Preferred, 7%		7,000.00
	,, Dividend—Common, $1.50		3,000.00
	,, Reserve Fund		8,000.00
	Capital Surplus	5,000.00	
	To Organization Expense		5,000.00
	To write off the Capital Expense by applying against it a part of the Capital Surplus.		

The Journal entries given indicate that charges for depreciation, provision for bad debts, accrued charges, etc., are made only in the operating accounts, and that no account had been previously charged. The more direct method has been followed, since the purpose is to direct attention to the operating accounts rather than to the accounting features behind them.

Some alternative entries follow—

(*a*) For Wages Accrued—

	Wages—Direct	$1,000.00	
	To Wages Accrued or Accrued Charges		$1,000.00
and			
	Manufacturing Account	61,000.00	
	To Wages—Direct		61,000.00
	If the first entry above were not made, the credit to Wages is $1,000.00 greater than the charge and the Accrued amount is set up automatically as a liability.		

(*b*) Depreciation—

	Depreciation in Factory Buildings	2,000.00	
	To Reserve for Depreciation—Factory Buildings		2,000.00
and			
	Manufacturing Account	2,000.00	
	To Depreciation on Factory Buildings		2,000.00

The same form would be followed in the other cases. In this way the expense is recorded before it is transferred to the operating account. The above alternative methods are longer, and give the same results but are technically the correct methods.

The same applies to provision for bad debts. A special account may be charged and then closed to Profit and Loss instead of the charge being made to Profit and Loss when the reserve is credited.

(*c*) Patents—

A reserve could, if desired, be set up against patents instead of writing down the asset by direct credits. The elements of time and possibly obsolescence enter in, but not that of wear and tear. The time is definite.

Dr. *Manufacturing* *Cr.*

Work in Process, Jan. 1			$18,000.00	Raw Material—Inventory	$50,000.00
Raw Material, Jan. 1		$45,000.00		Work in Process	20,000.00
Raw Material—				Cost of Goods finished—to Trading Account	311,300.00
Purchases	$190,000.00				
Less Returns	200.00	189,800.00			
Freight and Duty on Raw Material		15,000.00	249,800.00		
Wages—Direct			61,000.00		
Factory Overhead—					
Wages—Indirect		8,000.00			
Taxes—Factory		1,800.00			
Insurance		700.00			
Factory Expense		12,000.00			
Salaries—Factory		10,000.00			
Depreciation—Factory Building		2,000.00			
Depreciation—Plant and Machinery		16,000.00			
Patents—Written off		2,000.00	52,500.00		
			$381,300.00		$381,300.00

For alternative method see next page

Dr. *Manufacturing* *Cr.*

Work in Process, Jan. 1			$18,000.00	Work in Process	$20,000.00
Raw Material, Jan. 1		$45,000.00		Cost of Goods finished—to Trading Account	311,300.00
Raw Material—					
Purchases	$190,000.00				
Less Returns	200.00	189,800.00			
Freight and Duty on Raw Material		15,000.00			
		249,800.00			
Less Raw Material Inventory		50,000.00			
Cost of Raw Material Used			199,800.00		
Wages Direct			61,000.00		
Factory Overhead—					
Wages—Indirect		8,000.00			
Taxes—Factory		1,800.00			
Insurance—Factory		700.00			
Factory Expense		12,000.00			
Salaries—Factory		10,000.00			
Depreciation—Factory Buildings		2,000.00			
Depreciation—Plant and Machinery		16,000.00			
Patents—Written off		2,000.00	52,500.00		
			$331,300.00		$331,300.00

Dr.		*Trading*		*Cr.*
Stock—Finished Goods, Jan. 1	$24,000.00	Sales	$380,000.00	
Cost of Goods Manufactured	311,300.00	*Less* Returns	400.00	$379,600.00
Purchases, Finished Goods	4,000.00			
Freight and Duty on Purchases	300.00			
	339,600.00			
Less Stock—Finished Goods, Dec. 31	28,000.00			
Cost of Goods Sold	311,600.00			
Gross Profit	68,000.00			
	$379,600.00			$379,600.00

Dr.		*Profit and Loss*		*Cr.*
Selling Expenses—			Gross Profit—Trading	$68,000.00
Salesmen's Salaries	$8,000.00		Cash Discounts earned	1,800.00
Salesmen's Expenses	6,000.00			
Advertising	2,500.00			
Freight on Sales	300.00	$16,800.00		
Administration Expenses—				
Salaries—Office	10,000.00			
Office Expenses	4,000.00			
Insurance—Office	100.00			
Taxes—Office	200.00			
Depreciation—Office Building	150.00			
Depreciation—Office Equipment	400.00	14,850.00		
Incidental Financial Expense—				
Provision for Bad Debts	860.00			
Bank Interest—Temporary Loans	300.00			
Cash Discount allowed	4,000.00	5,160.00		
Balance—Profit from Direct Operations		32,990.00		
		$69,800.00		$69,800.00
Balance—Total Operating Profit		$35,190.00	Balance—Profit from Direct Operations	$32,990.00
			Interest earned on Sinking Fund	2,200.00
		$35,190.00		$35,190.00
Interest on Bonds		$8,400.00	Balance—Operating Profit	$35,190.00
Discount on Bonds		200.00		
Bank Interest—Continuous loans		3,700.00		
Balance—Net Profit		22,890.00		
		$35,190.00		$35,190.00
To Appropriation Account		$22,890.00	Balance—Net Profit	$22,890.00

Dr. *Profit and Loss Appropriation* *Cr.*

Dec. 31.	Federal Income Tax	$2,109.00	Jan. 1.	Balance	$8,700.00
	Sinking Fund Reserve	6,000.00	Dec. 31.	Net Profit for year	22,890.00
	Sinking Fund Surplus	200.00			
	Dividend—Preferred	7,000.00			
	Dividend—Common	3,000.00			
	Reserve Fund	8,000.00			
	Balance	5,281.00			
		$31,590.00			$31,590.00
			19—		
			Jan. 1.	Balance—Unappropriated	$5,281.00

Calculation of Income Tax. Income Tax rates are subject to change, but the rate for corporations at the time of writing is 10 per cent. on net profits in excess of $2,000.00. Should the operating accounts include charges not allowed for Income Tax purposes, these must be allowed for and added to the net profit when calculating the tax. Likewise, if capital profits were erroneously credited as operating income, these would be deducted.

The amount of discount on bonds amortized through interest on bonds to arrive at the effective interest cost is not, under a ruling, allowed as a deduction.

Net Profit for year as shown in the Profit and Loss Account	$22,890.00
Add—Bond Discount written off	200.00
	23,090.00
Deduct Exemption	2,000.00
Taxable Income	$21,090.00

Tax, 10% of $21,090.00 or $2,109.00.

THE ILLUSTRATIVE COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Current			
Bank		$12,000.00	
Accounts Receivable	$30,000.00		
Bills Receivable	32,000.00		
	62,000.00		
Less Reserve for Bad Debts	1,860.00	60,140.00	
Inventories—			
Finished Goods	28,000.00		
Work in Process	20,000.00		
Raw Material	50,000.00	98,000.00	$170,140.00
Deferred Charges			
Unexpired Insurance		100.00	
Bond Discount		1,800.00	1,900.00
Sinking Fund Investment			
Cash and Securities	53,200.00		
Due to Fund from Current Assets	4,000.00		57,200.00
Fixed—Tangible			
Land		20,000.00	
Buildings—Factory	80,000.00		
Less Reserve for Depreciation	6,000.00	74,000.00	
Buildings—General Office	6,000.00		
Less Reserve for Depreciation	550.00	5,450.00	
Plant and Machinery	160,000.00		
Less Reserve for Depreciation	48,000.00	112,000.00	
Office Equipment	4,000.00		
Less Reserve for Depreciation	1,400.00	2,600.00	214,050.00
Other Fixed Assets			
Patents		18,000.00	
Goodwill		20,000.00	38,000.00
			$481,290.00

Continued on next page

Liabilities, Capital and Surplus

Current			
Accounts Payable		$12,000.00	
Bills Payable		10,000.00	
Bank Loan		50,000.00	
Federal Income Tax		2,109.00	
Sales Tax		300.00	
Wages Unpaid		1,000.00	
Bond Interest Accrued		2,400.00	
Dividends—Preferred		7,000.00	
Dividends—Common		3,000.00	
Due to Sinking Fund		4,000.00	$91,809.00
Fixed (*or Deferred*)			
Bonds Issued			140,000.00
Shareholders' Equity—			
Capital Stock—			
Preferred, Subscribed	$100,000.00		
Less Unpaid Calls	6,000.00	94,000.00	
Common—Represented by 2,000 shares without par value	50,000.00		
Reserve Fund	38,000.00		
Sinking Fund Reserve	56,000.00		
Sinking Fund Surplus	1,200.00		
Unappropriated Profits	5,281.00		
Capital Surplus	5,000.00	155,481.00	249,481.00
			$481,290.00

A passing reference to some of the matters dealt with in the solution may help to render the accounts and statements clearer.

Purchases and Sales. The journal entries indicate that Returned Purchases Account is closed into Purchases, and Returned Sales into Sales but, as the amounts appear in the Trial Balance, they are shown as deductions and the net amount extended.

Cost of Goods Manufactured. Since the Manufacturing Account is one section of the operating account, a journal entry to close it and transfer the balance to the Trading Account is not actually necessary but is given, better to illustrate the procedure.

Manufacturing Account. The first form is correct, from the point of view of book-keeping. The second form includes a statement feature as the Raw Material inventory is deducted from the total instead of being credited to the Manufacturing Account. The effect is the same, but the second form shows the cost of Raw Material used. As the operating accounts are prepared only at the close of a period there should be no practical objection to making the deduction in this form. A further advantage is evident since the second form shows that the total cost put into process was $331,300.00, and that from this there is $20,000.00 of Work in Process, and $311,300.00 of goods finished. The second form appears to be of greater practical value and conforms with Accounting rather than with Book-keeping theory.

Profit and Loss Account—Financial Cost and Revenue. It will be observed that a distinction has been made between what may be termed incidental financial cost and revenue, special financial revenue, and interest on long term loans. A plan followed by some authorities is to show all financial items, including cash discounts and even provision for bad debts, as well as interest on long term loans, and financial revenue in one section between the operating profit and the net profit. In the plan followed in the illustration, the incidental financial expense, as well as cash discounts earned, have been brought in after the administrative expenses but as part of the operating section. These are incidental to the operating transactions, and cannot in themselves be said to represent a cost of, or revenue from, borrowed capital. The bank interest on temporary loans has been included as an incidental item, since those loans do not indicate the need of additional capital throughout the year. A distinction has been made, however, between the profit from direct operations and the whole operating profit, with the interest earned on the Sinking Fund brought in between the two. The reason for this is that from direct operations there was a profit of $32,990.00. This was the amount earned by all the capital employed, except the amount of the Sinking Fund, which is in the form of investments outside of direct operations, and the rate earned by direct operations can be determined. The calculation for this is later shown, as well as the percentage of the whole operating profit to all capital employed. The interest earned on Sinking Fund is a return on a portion of the company's assets, and so constitutes a part of what was earned by the whole capital employed by the corporation. It is, therefore, brought in before the total earned profit is shown and before the deductions are made for the interest on long term loans.

An entry may have been made—

Interest on Bonds, *Dr.*	$200.00	
To Discount on Bonds		$200.00

and the Interest Account closed to Profit and Loss at $8,600.00. The charge has been made in the Profit and Loss Account in the example, that attention may be drawn to the item more directly. The bank interest, $3,700.00, has been charged in the same section because bank loans remain fairly constant throughout the year. This does not mean that it was always the same loan, but the amount of credit borrowed continued at practically the same amount. This differs from the temporary loans in that it indicates the need of constant capital. The net profit as finally brought down represents the return on the shareholders' equity.

The cash discounts earned would, in a statement, likely be deducted from the incidental financial expense and the net amount extended. This may have been done in the account, but the form in which these are given shows very clearly the amount of the charge for incidental financial expense and also the revenue earned through cash discounts.

Patents. It will be observed that 10 per cent. has been written off the patents and this amount charged to operations. It is assumed that the patents have been purchased for cash or other tangible value, and that at the time of purchase they had ten years of life remaining. When the patents are purchased for cash or other tangible value and the manufacturing operations are carried on under the patents, the amount of their cost may be written off by a proportionate charge to operations in each year of their life, and this amount allowed as a charge before net profits for Income Tax purposes. If, on the other hand, the amount of patents had been set up at an arbitrary figure and cash or other tangible value had not been given for them, it is probable that the amount written off would not be allowed as an operating charge for Income Tax purposes. This distinction is rather important as it means that the amount written off patents may or may not be allowed as a charge before net profit when calculating Income Tax. It depends on the consideration given for the patents and their relation to operations.

Percentage Statements

NOTE. As Income Tax is a tax on net profits and not an operating charge, it does not enter directly into earning power. It is a factor only so long as the law so decrees, so the statements that follow are calculated both with and without taking the tax into consideration.

(a) Statement of Direct Operating Rate of Earning. The amount of shareholders' equity, exclusive of Sinking Fund Reserve and Surplus, was $100,000.00 Preferred, $50,000.00 Common, $30,000.00 Reserve Fund, Unappropriated Profits $8,700.00, and Capital Surplus $10,000.00 or $198,700.00. To this must be added Borrowed Capital of $140,000.00 plus $50,000.00, making a total of $388,700.00.

The direct operating profit is $32,990.00.

Rate of earning $\frac{32990}{388700}$ of $\frac{100}{1}$ or 8·487 per cent.

Allowing for Income Tax, this would be $\frac{30881.00}{388700.00}$ of $\frac{100}{1}$ or 7.43 per cent.

(b) Statement of Total Operating Profit to All Capital Employed. To $388,700.00 add Sinking Fund Reserve $50,000.00 and Sinking Fund Surplus $1,000.00, making a total of $439,700.00. The total profit from operations is $35,190.00.

Rate of earning $\frac{35190}{439700}$ of $\frac{100}{1} = 8.003$ per cent.

After allowing for Income Tax this would be $\frac{33081.00}{439700.00}$ of $\frac{100}{1}$ or 7.523 per cent.

The reason this rate is lower than (*a*) is that the rate earned on the Sinking Fund Investment was lower than the rate from direct operations.

(c) Rate of Net Profit to Shareholders' Equity. Shareholders' equity as in (*a*) \$198,700.00 plus Sinking Fund Reserve and Sinking Fund Surplus \$51,000.00 is \$249,700.00. Net Profit is \$22,890.00.

Rate of return is $\frac{22890}{249700}$ of $\frac{100}{1} = 9.167$ per cent.

After allowing for Income Tax this is $\frac{20781.00}{249700.00}$ of $\frac{100}{1}$ or 8.322 per cent.

This rate is higher than those in (*a*) and (*b*) for the reason that the rate of profit from operations is higher than the rate paid on borrowed capital funds. This indicates that under the conditions of the year in question it has been more profitable to the present shareholders for the company to use these borrowed funds than to have issued further shares and avoided borrowing. The difference between the rate paid for money borrowed and the higher rate it earned is a benefit to the corporation and to the shareholders.

Had the conditions been below normal, and the rate earned had been lower than the rate paid on borrowed funds, a part of the amount earned by the shareholders' equity would have been required to pay the interest, and the return on the shareholders' equity would have been lower than the rate earned. Under such conditions borrowing would prove to be unprofitable to the present shareholders.

It is frequently stated that if funds were not borrowed the amount of the interest would be available for dividends, but this does not properly express the situation, because the amount would not be available on present shares. If funds were not borrowed there would be, to supply the same amount of capital funds, a larger issue of shares, and the return in this instance would have been lower than the return to shareholders under the conditions set out in this case. It would have been 8.003 per cent. instead of 9.167 per cent., or, after Income Tax, 7.523 per cent. instead of 8.322 per cent.

(d) Rate of Return on Share Capital. The net profit is \$22,890.00, from which must be deducted Income Tax \$2,109.00, thus leaving \$20,781.00 which, on \$100,000.00 Preferred, gives a return of 20.781 per cent. or nearly three times dividend requirements. After provision for Sinking Funds \$6,200.00 there is still \$14,581.00, or over twice Preferred dividend requirements.

After allowing for Income Tax and Preferred dividends of \$7,000.00 there remains \$13,781.00 which, on 2,000 shares Common, gives a return of \$6.89 a share against dividend requirements of \$1.50 or \$3,000.00. It is assumed that the Preferred dividends are declared on the par value. They will be based on par unless otherwise stated.

(e) Earning of Bond Interest. After allowing for interest on bank loans, and for Income Tax, there remains from operating profit $29,381.00, which is over three times Bond Interest requirements. Bond interest is a compulsory charge to be met before profits for dividends can be determined.

Other Features

The amount for Sinking Fund Investment must be paid over, but the appropriations for Sinking Fund Reserve and Sinking Fund Surplus, while very much to be desired, are not compulsory and have not entered into the calculations.

While a definite rule cannot be given as to what relation should exist between Current Assets and Current Liabilities, since different factors enter into different businesses, in a business of this kind a relation of 2 to 1 would be considered fair. The actual relation is $170,140.00 to $91,809.00 or over 1·85 to 1, probably a fair relation.

If the goods manufactured were sold over a long period, and payable in instalments, the relation may need to be considerably higher.

Whether the total of Accounts and Bills Receivable is reasonable will depend on the terms of sale.

If the average period of credit allowed was one month, the receivables should not greatly exceed the last month's sales. If the average terms were one and one-half months and the sales for the last month and a half were $50,000.00, the total of $62,000.00 would indicate that collections are somewhat slow, and this factor tends to lower the real value of the receivables.

The source of the capital surplus is not stated. It may have arisen from the issue of Preferred shares at a premium, which is unlikely, or the amount of consideration received from the issue of Common shares may have been credited in part to capital stock and in part to capital surplus. It may have originated from the sale of fixed assets at a profit.

The capital surplus has been applied, in part, to write off the capital expense, due to cost of organization.

The fixed assets greatly exceed the issued capital. Apparently the Common shares were issued chiefly, at least, for Patents and Goodwill, and possibly for part of the organization expense.

Even the proceeds from the issue of bonds, together with the receipts from the issue of Preferred shares, amount to less than the tangible fixed assets $270,000.00 (Cost). The source of other funds includes amounts charged for depreciation $55,950.00, plus amounts written off the patents,

and earned surplus retained in the business and represented by Reserve Fund and Unappropriated Profits. The Sinking Fund Reserve and the Sinking Fund Surplus also constitute earned surplus, but the amount of these has been segregated in the assets as Sinking Fund Investment. It is apparent that the fixed assets were not all acquired at one time but have been added to from time to time.

Working Capital would be required from the beginning.

Assuming that the bonds are secured by tangible fixed assets, the issue is $140,000.00 against security, originally, of $270,000.00 or slightly over 50 per cent. The present position is a security of $214,050.00 against a net debt of $140,000.00 – Sinking Fund Investment $57,200.00, or $82,800.00, a much improved relation.

Operating Statements

When presenting an outline of operations to an executive, a statement rather than accounts is usually desired.

There is a real distinction to be made between Accounts and Statements.

Accounts are built up within the ledger by the process of posting entries in the books of original entry. Operating accounts are prepared in this way. The original entries in that case refer chiefly to adjustments that must be made at the close of a period and by transfers, from the working accounts to the operating accounts, of information relative to the operations.

Operating Statements are prepared from information contained in the accounts but no entries are made in the preparation of a statement. The Balance Sheet is a statement, not an account.

Operating Accounts are built up in the ledger and the information they contain can be presented in statement form.

When preparing a statement of operations the divisions made in the accounts should not be lost sight of, and the statement should convey all the information possible.

Statements are prepared in different forms. Many prefer to prepare them in much the same form as the operating accounts have been presented. If an accounting student is asked to prepare Manufacturing Account, etc., the account form rather than the complete statement form is required.

To illustrate a form of statement of operations, the information contained in the accounts already presented is used. This is followed by a statement of net profits.

THE ILLUSTRATIVE COMPANY, LTD.

Operating Statement

Year Ending December 31, 19—

Sales			$380,000.000	
Less Returns and Allowances			400.00	$379,600.00
Deduct: Cost of Goods Sold—				
Work in Process, Jan. 1			18,000.00	
Cost of Materials used			199,800.00	
Wages—Direct (Productive)			61,000.00	
			278,800.00	
Manufacturing Expenses				
Wages—Indirect		$8,000.00		
Taxes—Factory		1,800.00		
Insurance—Factory		700.00		
Factory Expense		12,000.00		
Salaries—Factory		10,000.00		
Depreciation—Factory Building		2,000.00		
Depreciation—Plant and Machinery		16,000.00		
Patents—Written off		2,000.00	52,500.00	
Total Cost of Manufacture			331,300.00	
Deduct: Work in Process, Dec. 31			20,000.00	
Cost of Finished Goods Manufactured			311,300.00	
Finished Goods on Hand, Jan. 1			24,000.00	
Finished Goods Purchased			4,000.00	
Freight and Duty on Finished Goods			300.00	
			339,600.00	
Less Finished Goods on Hand, Dec. 31			28,000.00	
Cost of Goods Sold				311,600.00
Gross Trading Profit				68,000.00
Deduct: Operating Expenses				
Selling Expenses				
Salesmen's Salaries	$8,000.00			
Salesmen's Expenses	6,000.00			
Advertising	2,500.00			
Freight on Sales	300.00	$16,800.00		
Administration Expenses				
Salaries—Office	10,000.00			
Office Expenses	4,000.00			
Insurance—Office	100.00			
Taxes—Office	200.00			
Depreciation—Office Building	150.00			
Depreciation—Office Equipment	400.00	14,850.00		
Incidental Financial Expenses				
Provision for Bad Debts	860.00			
Bank Interest—Temporary Loan	300.00			
Cash Discounts Allowed	4,000.00			
	5,160.00			
Less Cash Discounts earned	1,800.00	3,360.00		35,010.00
Direct Operating Profit				32,990.00
Add: Other Income—				
Interest earned on Sinking Fund				2,200.00
Total Profit from Operations				35,190.00
Deduct: Interest on Long Term Loans, etc.—				
Interest on Bonds	8,400.00			
Discount on Bonds (Proportion)	200.00			
Bank Interest	3,700.00			12,300.00
Net Profit				$22,890.00

Statement of Net Profits and Appropriations

Unappropriated Profits—Jan. 1		$8,700.00	
Net Profit for year		22,890.00	
Total available for appropriation			$31,590.00
Federal Income Tax		2,109.00	
Sinking Fund Reserve—			
Annual Instalment	$4,000.00		
Interest as estimated	2,000.00	6,000.00	
Sinking Fund Surplus—Excess			
Interest over estimate		200.00	
Dividend—Preferred, 7%		7,000.00	
Dividend—Common, $1.50 a share		3,000.00	
Reserve Fund		8,000.00	
Total Appropriations			26,309.00
Balance Unappropriated			$5,281.00

Statement of Material Used

Raw Material on Hand, Jan. 1		$45,000.00
Add: Raw Material Purchased	$190,000.00	
Less Raw Material Returned	200.00	189,800.00
Freight and Duty on Raw Material		15,000.00
Total Raw Material		249,800.00
Deduct: Raw Material on Hand, Dec. 31		50,000.00
Cost of Raw Material Used		$199,800.00

Had there been supplies for the factory, these would be dealt with in the Manufacturing Expenses.

CHAPTER FIFTEEN

AMALGAMATION OF COMPANIES

AMALGAMATION of Limited Companies is the process by which two or more companies are joined together or combined through the whole undertaking of one company being acquired by another by direct purchase or by the formation of an entirely new company for the purpose of acquiring the undertakings of two or more companies, which are thus combined in the new company.

There are at least two pre-existing companies involved in an amalgamation. An amalgamation thus differs from a reconstruction, in which a new company may be formed for the purpose of acquiring the undertaking of *one* already existing company.

Reasons for Amalgamations. Various reasons or conditions may lead to a desire for the amalgamation of companies, so that amalgamations cannot be said to arise always from the same cause.

Companies, although prosperous and carrying on a large business but competing one against the other, may find that, due to this competition, it becomes increasingly difficult to maintain their usual volume of business and profits, with the result that the prices of their products tend to lower levels. The amalgamation of the companies helps to reduce or eliminate the competition and to adjust the situation to more healthy conditions.

Very often it is believed possible, if a number of concerns can be brought under one management, to effect economies in operating and management costs, with resultant increased profits or greater stability.

Should the operations and products of separate companies be such that the output of one may constitute the usual raw material for another, this relation between the products may lead to a desire to amalgamate the companies and thus control the final product through all its processes. The element of economy as well as of control would also enter in this case. The natural means in an instance such as this is a control through shares, with separate entities maintained.

An economy in operating and management costs may enable the new company to lower the price of its product to the benefit of both shareholders and public, through a division of the reduction between the corporation and the public.

One or more companies may find it difficult to earn a satisfactory return on capital invested, and so desire to sell their business to advantage, if

possible. At the same time, another company may be desirous of eliminating competition by purchasing the business of a competitor, if this can be accomplished on reasonable terms, in the belief that the business purchased can be made profitable.

Process of Amalgamation. From the definition already given, it is apparent that amalgamations may be brought about by the absorption of one company by another, which acquires the undertaking, or by the formation of a new company for the purpose of acquiring the undertakings of those to be amalgamated.

Frequently, control of one company by another is obtained through the purchase of sufficient of the shares to give a controlling interest, both or all companies to continue as separate entities. This may be considered under absorption rather than under actual amalgamation.

The procedure leading to the amalgamation of companies is not covered by the same provisions under all of the Companies Acts in Canada. Under the Companies Act of British Columbia amalgamation is provided for through the court.

The Dominion Act includes the right to amalgamate under ancillary powers. Some other Acts are practically silent on the point, though the purchase of other businesses in the same line may be authorized by charter.

The usual procedure is more nearly outlined in the Ontario Act, the provisions of which follow, not with a view so much to quoting the Act as of giving a clear outline of the steps required, and which would be natural in any case.

"Any two or more corporations to which this Act applies having the same or similar objects within the scope of this Act may, in the manner herein provided, amalgamate and may enter into all contracts and agreements necessary to such amalgamation.

"The corporations proposing to amalgamate may enter into a joint agreement for the amalgamation prescribing the terms and conditions thereof, the mode of carrying the same into effect, and stating the name of the new corporation, the names, callings, and places of residence of the first directors thereof, and how and when the subsequent directors shall be elected, with such other details as may be necessary to perfect the amalgamation and to provide for the subsequent management and working of the new corporation, and in cases of companies the number of shares of the capital, the par value of each share, and the manner of converting the share capital of each of the companies into that of the new company.

"The agreement shall be submitted to the shareholders or members of each of the corporations at a general meeting thereof called for the purpose of taking the same into consideration.

"At such meetings of the shareholders or members the agreement shall

be considered, and if two-thirds of the votes of all the shareholders or members of each of such corporations are for the adoption of the agreement that fact shall be certified upon the agreement by the secretary of each of such corporations under the corporate seal thereof.

"Thereupon the several corporations by their joint petition may apply to the Lieutenant-Governor for letters patent confirming the agreement, and on and from the date of the letters patent the corporations shall be deemed and taken to be amalgamated and to form one corporation by the name in the letters patent provided, and the corporation so incorporated shall possess all the property, rights, privileges, and franchises and be subject to all the liabilities, contracts, disabilities, and duties of each of the corporations so amalgamated."

Consideration. The usual consideration given by the new company, under the agreement for the assets acquired, less liabilities, is the issue of shares in the new company to the holders of shares in the pre-existing companies in accord with the net value placed upon each business acquired. This calls for a very careful valuation of assets in each company, not merely as to themselves but in relation to each other, on the basis of asset values generally and of earning power. There should, from the valuation, be an equitable relation among all shareholders in the new company. An investigation should precede an amalgamation.

Before discussing some of the points of a special nature that arise in the accounting procedure, an example is being taken and as this is developed the need for discussion will become more apparent.

Problem. The X Company, Ltd., and the Y Company, Ltd., agree to amalgamate under the name of Z Company Ltd., which is formed with an authorized capital of $300,000.00. The amalgamation is effected as of January 1, 19–.

The shareholders of the X and of the Y companies agree to accept shares in the new (Z) company in settlement for their equities. X Company, Ltd., receives $95,000.00, and Y Company, Ltd., $50,000.00. The assets are taken over at book values, except that in the case of those taken over from Y the Z Company added $1,000.00 to the Reserve for Bad Debts, and reduced Plant and Machinery $2,600.00. X is given $3,000.00 in shares for his services in promoting the amalgamation.

The Balance Sheets of the two amalgamating companies as at the date of amalgamation follow—

(*a*) Make the entries necessary to close the accounts of each of the companies.

(*b*) Make, in journal form, the entries necessary to open the books of the Z Company, Ltd.

(*c*) Prepare the opening Balance Sheet of Z Company, Ltd.

THE X COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets

Current			
Cash in Bank		$2,000.00	
Accounts Receivable	$20,000.00		
Bills Receivable	18,400.00		
	38,400.00		
Less Reserve for Bad Debts	1,400.00	37,000.00	
Stock Inventories		22,000.00	$61,000.00
Fixed			
Land		8,000.00	
Buildings	13,400.00		
Less Reserve for Depreciation	2,000.00	11,400.00	
Plant and Machinery	40,000.00		
Less Reserve for Depreciation	8,000.00	32,000.00	
Office Equipment	2,000.00		
Less Reserve for Depreciation	400.00	1,600.00	53,000.00
			$114,000.00

Liabilities

Current		
Accounts Payable	$8,000.00	
Bills payable	16,000.00	
Bank Loan	5,000.00	$29,000.00
Fixed		
Mortgage		5,000.00
Shareholders' Equity		
Capital Stock—Subscribed and Paid	60,000.00	
Reserve Fund	16,000.00	
Unappropriated Profits	4,000.00	80,000.00
		$114,000.00

THE Y COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets

Current			
Cash in Bank		$200.00	
Accounts Receivable	$12,000.00		
Bills Receivable	10,000.00		
	22,000.00		
Less Reserve for Bad Debts	1,000.00	21,000.00	
Stock		25,000.00	$46,200.00
Fixed			
Land		12,000.00	
Buildings	15,000.00		
Less Reserve for Depreciation	3,000.00	12,000.00	
Plant and Machinery	30,000.00		
Less Reserve for Depreciation	6,000.00	24,000.00	
Office Equipment	3,000.00		
Less Reserve for Depreciation	600.00	2,400.00	50,400.00
			$96,600.00

Liabilities

Current		
Accounts Payable	$15,000.00	
Bills Payable	18,000.00	$33,000.00
Fixed		
Mortgage		10,000.00
Shareholders' Equity		
Capital Stock—		
Subscribed and Paid	60,000.00	
Less Deficit	6,400.00	53,600.00
		$96,600.00

Sotution. (*a*)

(i) Entries to close the accounts of X Company, Ltd.

Reserve for Depreciation—Buildings	$2,000.00	
To Buildings		$2,000.00
Reserve for Depreciation,—Plant, etc.	8,000.00	
To Plant and Machinery		8,000.00
Reserve for Depreciation—Office Equipment	400.00	
To Office Equipment		400.00
Entries to close out Depreciation Reserves.		
Realization	115,400.00	
To Cash		2,000.00
,, Accounts Receivable		20,000.00
,, Bills Receivable		18,400.00
,, Stock-Inventories		22,000.00
,, Land		8,000.00
,, Buildings		11,400.00
,, Plant and Machinery		32,000.00
,, Office Equipment		1,600.00
To close Assets to Realization.		
Accounts Payable	8,000.00	
Bills Payable	16,000.00	
Bank Loan	5,000.00	
Mortgage	5,000.00	
Reserves for Bad Debts	1,400.00	
To Realization		35,400.00
To transfer Liabilities to Realization.		
Z Company, Ltd.	95,000.00	
To Realization		95,000.00
To charge Z Company with Sale Price.		
Capital Stock	60,000.00	
Reserve Fund	16,000.00	
Profit and Loss Appropriation	4,000.00	
Realization	15,000.00	
To Shareholders		95,000.00
To close realization and transfer the excess realized over book values, together with other amounts representing Shareholders' Equity, to the credit of shareholders.		
Shares in Z Company, Ltd.	95,000.00	
To Z Company, Ltd.		95,000.00
Consideration received in settlement.		
Shareholders	95,000.00	
To Shares in Z Company, Ltd.		95,000.00
Distribution of consideration among shareholders and close out Accounts of the Company.		

(ii) Entries to close accounts of Y Company, Ltd.

Reserve for Depreciation—Buildings	$3,000.00	
To Buildings		$3,000.00
Reserve for Depreciation—Plant and Machinery	6,000.00	
To Plant and Machinery		6,000.00
Reserve for Depreciation—Office Equipment	600.00	
To Office Equipment		600.00
To close Depreciation Reserves and record Fixed Assets at net book value.		
Realization	97,600.00	
To Cash		200.00
,, Accounts Receivable		12,000.00
,, Bills Receivable		10,000.00
,, Stock—Inventories		25,000.00
,, Land		12,000.00
,, Buildings		12,000.00
,, Plant and Machinery		24,000.00
,, Office Equipment		2,400.00
Closing Asset Accounts to Realization.		
Accounts Payable	15,000.00	
Bills Payable	18,000.00	
Mortgage	10,000.00	
Reserve for Bad Debts	1,000.00	
To Realization		44,000.00
To credit Realization with liabilities assumed by Z Company.		
Z Company, Ltd.	50,000.00	
To Realization		50,000.00
Charging Z Company with amount under Sales Agreement.		
Capital Stock	60,000.00	
To Shareholders		60,000.00
Shareholders	10,000.00	
To Profit and Loss Appropriation—Deficit		6,400.00
,, Realization		3,600.00
To charge shareholders with Deficit and with Loss in Realization.		
Shares in Z Company, Ltd.	50,000.00	
To Z Company, Ltd.		50,000.00
Consideration received.		
Shareholders	50,000.00	
To Shares in Z Company, Ltd.		50,000.00
Distribution of consideration among shareholders to close out the Accounts of the Company.		

(*b*) Entries to open the books of Z Company, Ltd.

(i) To record purchase of X Company, Ltd., undertaking.

Cash	$2,000.00	
Accounts Receivable	20,000.00	
Bills Receivable	18,400.00	
Stock—Inventories	22,000.00	
Land	8,000.00	
Buildings	11,400.00	
Plant and Machinery	32,000.00	
Office Equipment	1,600.00	
Goodwill	15,000.00	
To Accounts Payable		$8,000.00
,, Bills Payable		16,000.00
,, Bank Loan		5,000.00
,, Mortgage		5,000.00
,, Reserve for Bad Debts		1,400.00
,, X Company, Ltd.		95,000.00
To record Assets acquired, Liabilities assumed, and credit X Company with amount of purchase price.		
Subscribers (X Company)	95,000 00	
To Capital Stock		95,000.00
X Company, Ltd.	$95,000.00	
To Subscribers		$95,000.00
To record subscription by X Company and issue of shares to cover consideration received.		

(ii) To record purchase of Y Company, Ltd., undertaking.

Cash	$200.00	
Accounts Receivable	12,000.00	
Bills Receivable	10,000.00	
Stock—Inventories	25,000.00	
Land	12,000.00	
Buildings	12,000.00	
Plant and Machinery	21,400.00	
Office Equipment	2,400.00	
To Accounts Payable		$15,000.00
,, Bills Payable		18,000.00
,, Mortgage		10,000.00
,, Reserve for Bad Debts		2,000.00
,, Y Company, Ltd.		50,000.00
To bring into the Accounts the Assets acquired and Liabilities assumed, and credit Y Company with purchase price.		
Subscriber (Y Company)	50,000.00	
To Capital Stock		50,000.00
Y Company, Ltd.	50,000.00	
To Subscribers		50,000.00
To record subscription by Y Company and issue of shares to cover the amount of the purchase price.		
Subscriber	3,000.00	
To Capital Stock		3,000.00
Organization Expense	3,000.00	
To Subscriber		3,000.00
Issue of $3,000.00 in shares to X (an individual) for services in organization.		

(c) THE Z COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets

Current			
Cash in Bank		$2,200.00	
Accounts Receivable	$32,000.00		
Bills Receivable	28,400.00		
	60,400.00		
Less Reserve for Bad Debts	3,400.00	57,000.00	
Stock—Inventories		47,000.00	$106,200.00
Fixed			
Land		20,000.00	
Buildings		23,400.00	
Plant and Machinery		53,400.00	
Office Equipment		4,000.00	100,800.00
Goodwill			15,000.00
Organization Expense			3,000.00
			$225,000.00

Liabilities

Current		
Accounts Payable	$23,000.00	
Bills Payable	34,000.00	
Bank Loan	5,000.00	$62,000.00
Fixed (or Deferred)		15,000.00
Mortgages		
Shareholders' Equity		
Capital Stock—Subscribed and Paid		148,000.00
		$225,000.00

On a review of the foregoing entries and Balance Sheet, it becomes apparent that some explanations are desirable.

Goodwill. The amount of consideration given for X Company, Ltd., is $15,000.00 greater than the shareholders' equity disclosed in X's Balance Sheet. This indicates a consideration for Goodwill, to the account for which the excess of purchase price over the net value of tangible assets acquired is charged. X gave indications of successful operation and of a connection and reputation that should be of value to Z Company. As X Company's charter will be surrendered and as X will not compete with Z, it is clear that Z should receive any benefits arising from this connection.

The amount of consideration given for the undertaking of the Y Company was less than the shareholders' equity, as shown by its balance sheet. This has been applied to adjust the values of certain assets. Had it not been so applied there would have been a credit of $3,600.00. This would not have been set up as a surplus. There was no realization and, therefore, no profit. If left as a credit, it should have been held as a reserve against the assets and applied to the adjustment of their book values, as required.

Realization Account. The use of a Realization Account, into which all asset and liability accounts are transferred, and which is credited with the sale price, reduces the excess over book value realized, or the reverse, down to one amount. Deficit and Capital Stock Accounts are not closed to Realization as they relate to shareholders' equity only.

The Realization Account of the X Company, Ltd., follows—

Dr. *Realization* *Cr.*

19—				19—			
Jan. 1	Assets—Sundry	J. –	115,400.00	Jan. 1	Liabilities—Sundry	J. –	35,400.00
	Balance—excess realized over book values		15,000.00	Jan. 1	Z Co. Sale Price	J. –	95,000.00
			130,400.00				130,400.00
19—				19—			
Jan. 1	To Shareholders		15,000.00	Jan. 1	Balance		15,000.00

The amount, $15,000.00 is, to the company, in the nature of a profit on realization and, as the business is being closed out, it could have been closed to Profit and Loss, but it is probably better to transfer the amount to the credit of Shareholders' Account direct from Realization. The nature of the item differs from the amount shown as unappropriated profits that came from operations.

Shareholders' Account is used to bring together the amounts relating to the equity of the shareholders. Their equity is represented by Paid-up Capital and Surplus, or by Paid-up Capital less deficit.

Shareholders' Account of the X Company follows—

Dr. *Shareholders* *Cr.*

19—				19—			
Jan. 1	Balance—Total equity after realization		95,000.00	Jan. 1	Capital Stock—Paid-up	J. –	60,000.00
					Reserve Fund	J. –	16,000.00
					Profit and Loss Appropriation	J. –	4,000.00
					Realization	J. –	15,000.00
			95,000.00				95,000.00
19—				19—			
Jan. 1	Shares of Z Co.—Settlement	J. –	95,000.00	Jan. 1	Balance		95,000.00

After the profit or loss from realization is closed to the account set up for shareholders, that account will indicate the exact amount due to the shareholders in settlement and, when the consideration is given to them and their account charged, all accounts are closed.

The same principles necessarily apply to the Y Company, but conditions are not the same. The accounts for Realization and for Shareholders of Y Company are given to illustrate.

Dr. *Realization* *Cr.*

19—				19—				
Jan. 1	Assets—Sundry	J. –	97,600.00	Jan. 1	Liabilities—Sundry	J. –	44,000.00
					Z Co., Ltd.	J. –	50,000.00
					Balance—Loss in realization	J. –	3,600.00
			97,600.00				97,600.00
19—				19—			
Jan. 1	Balance—Loss		3,600.00	Jan. 1	Shareholders	J. –	3,600.00

Dr. *Shareholders* *Cr.*

19—				19—			
Jan. 1	Appropriation Account, Deficit	J –	6,400.00	Jan. 1	Capital Stock—Paid-up	J. –	60,000.00
	Realization—Loss	J. –	3,600.00				
	Balance—Net equity		50,000.00				
			60,000.00				60,000.00
19—				19—			
Jan. 1	Shares in Z Co., Settlement	J. –	50,000.00	Jan. 1	Balance	J. –	50,000.00

The profit or loss in realization adjusts the equity from the amount shown before realization to the amount at which it stands after realization.

Depreciation Reserves. Reserves for depreciation were closed out to the asset accounts affected because to the new company the assets are newly acquired. There cannot have been any depreciation as yet, and provision will be made on the basis of their cost and estimated life. The same result would have been obtained if the reserves had been credited to realization and the assets charged to realization at cost, but the method shown has been followed because these reserves were negative to the particular asset accounts and the book value in each case is the cost less the reserve for depreciation. The reserve for bad debts is carried along, as all accounts are transferred to Z and the reserve is applied only when accounts are actually written off.

Had the assets been taken over at other than book values the individual asset accounts need not be adjusted in the books of the vendors, as the adjustment is automatically effected through Realization Account. The

purchasing company records the assets at the values determined at the time. If no Realization Account had been used, the accounts for individual assets would require adjustment, or else the profit or loss on each asset would be shown in the account which would be closed to Profit and Loss.

Treatment of Surplus and Deficit. The X Company's balance sheet revealed an earned surplus in the form of Reserve Fund and Unappropriated Profits, and the surplus was increased through profit in realization.

The Y Company's balance sheet revealed a deficit and this was increased by the loss in realization.

The Z Company has neither surplus nor deficit, although it represents a combination of the X Company and the Y Company. The reason for this should be definitely understood.

Balance sheets are made up of the main divisions: Assets, Liabilities, and Proprietorship or Shareholders' Equity. This is further explained by saying that Assets are equal to the Liabilities plus Proprietorship, or Assets less Liabilities equal Proprietorship, or again, that the Proprietorship is the excess of Assets over Liabilities. It follows that the Shareholders' Equity must be and is represented by Assets. The Z Company purchased the assets and assumed the liabilities and the purchase price was the amount by which assets acquired, including Goodwill, exceeded the liabilities. It is clear that the shares issued by Z were for all the assets, including those that had represented the equity of the shareholders, including surplus, and that the amount is now *fully* represented by Capital Stock issued by the Z Company. In any event, Z Company could not have a surplus before it is organized and commences operations.

Expenses of Realization. Should there have been expenses that have been paid by the vendor companies, the amounts would be charged to Realization Account.

Bonds Outstanding. Should there have been bonds of one of both of the companies outstanding, provision could be made to exchange these for bonds in the new company. If this is effected at par, Realization is not affected, but if at a premium, Realization Account is charged and Bonds Account credited with the amount of the premium. Bonds of the new company would then be given in exchange for an amount including the premium.

Distribution of Consideration Received. In the books of X Company and Y Company the charge to Z Company was made to record the amount owing by Z Company in connection with the sale. The entries charging an account for Shares in Z Company, Ltd., were made to record the asset received in consideration for the sale. The directors of X Company

and of Y Company, or their liquidators, would give instructions as to the names of those to whom share certificates are to be issued, or, as is more likely, the shares would be first issued to the liquidators of X Company and of Y Company, and transfers made to the shareholders entitled to them. These shareholders of X Company and of Y Company would hand in their certificates issued by those companies and when the charters are surrendered the shares are cancelled. The consideration received should be definitely recorded. An entry charging the shareholders and crediting the Z Company without recording the consideration is not a desirable method.

Should the settlement with the shareholders involve fractions of shares, the probable method would be to issue to the liquidator of each company shares representing the total of the fractions. These are then realized at the best price obtainable, and the proceeds distributed *pro rata* among the parties entitled to the fractions.

Amalgamation by Absorption

The term absorption is applied to the process of one company, already established, buying the business of another. This differs from the case already dealt with, wherein a new company is formed to acquire the businesses of two or more other companies. In an absorption, one already existing company acquires the business of another. The company whose business is acquired is the only one whose identity is lost. The entries are very similar to those already given but to reveal the difference a short example is given.

Problem. Below are the Balance Sheets of the A Company, Ltd., and of the B Company, Ltd., as at January 1, 19— (condensed).

THE A COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry Current	$60,000.00
Sundry Fixed	80,000.00
	$140,000.00
Liabilities	
Sundry Current	$15,000.00
Shareholders' Equity—	
Capital Stock—Subscribed and Paid	100,000.00
Reserve Fund	20,000.00
Unappropriated Profits	5,000.00
	$140,000.00

THE B COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets

Sundry Current	$60,000.00
Sundry Fixed	55,000.00
	$115,000.00

Liabilities

Sundry Current	$5,000.00
Shareholders' Equity—	
Capital Stock—Subscribed and Paid	80,000.00
Reserve Fund	25,000.00
Unappropriated Profits	5,000.00
	$115,000.00

At this date A Company, Ltd., acquired the business of B Company, Ltd., for a purchase price of $100,000.00, payable by the issue of its (A Company's) shares. The shares of A Company are valued at $125.00 each, and the purchase is made on that basis. An allowance of $6,000.00 is made on B's fixed assets and $4,000.00 on stock in trade. B will be operated as a branch.

(*a*) Record the entries to close the accounts of the B Company, Ltd.

(*b*) Make the entries necessary in the books of the A Company, Ltd.

(*c*) Prepare the A Company's balance sheet as after the transaction is completed.

Solution. (*a*) Entries in books of B Company—

Realization	$115,000.00	
To Sundry Assets—Current		$60,000.00
,, Sundry Assets—Fixed		55,000.00
Sundry Liabilities	5,000.00	
To Realization		5,000.00
A Company, Ltd.	100,000.00	
To Realization		100,000.00
Capital Stock	80,000.00	
Reserve Fund	25,000.00	
Appropriation Account	5,000.00	
To Shareholders		110,000.00
Shareholders	10,000.00	
To Realization		10,000.00
To record loss in realization. This reduces Shareholders' Equity to $100,000.00.		

Shares in A Company, Ltd.	$100,000.00	
To A. Company, Ltd.		$100,000.00
Settlement consideration.		
Shareholders	100,000.00	
To Shares in A Company, Ltd.		100,000.00
Distribution of shares of A among shareholders.		

The accounts will be closed when these entries are posted.

(*b*) Entries in A Company's books—

Sundry Assets—Current	$56,000.00	
Sundry Assets—Fixed	49,000.00	
To Sundry Liabilities—Current		$5,000.00
,, B Company, Ltd.		100,000.00
To record Assets acquired, Liabilities assumed, and amount due B Company for purchase of business.		
Subscribers	100,000.00	
To Capital Stock		80,000.00
,, Premium on Shares		20,000.00
Subscription by B Company at $125.00.		
B Company, Ltd.	100,000.00	
To Subscribers		100,000.00
B Company's subscriptions covered by amount due for business purchased.		

(*c*) THE A COMPANY, LTD.

Balance Sheet

January, 1, 19—

Assets		
Sundry Current		$116,000.00
Sundry Fixed		129,000.00
		$245,000.00
Liabilities		
Sundry Current		$20,000.00
Shareholder's Equity—		
Capital Stock—Subscribed and Paid	$180,000.00	
Reserve Fund	20,000.00	
Premium on Shares	20,000.00	
Unappropriated Profits	5,000.00	225,000.00
		$245,000.00

The shares issued by A Company to B Company's liquidator are recorded by A Company in the usual way. In the books of B Company these shares are recorded at what they cost. The question of premium does not enter into the book entries, and it so happens that the exchange is made share for share so there will be no fractions of shares.

Purchase on the Basis of a Previous Balance Sheet

Reference has been made to the fact that a company buying the business of another cannot earn a realized surplus in doing so, and that a company cannot earn profits prior to its organization. The point involved arises when a company buys a business at a certain date but on the basis of a balance sheet of an earlier date.

Problem. The Balance Sheet of C Company, Ltd., on December 31, 19— was as below—

THE C COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$320,000.00
	$320,000.00
Liabilities	
Sundry	$40,000.00
Shareholders' Equity—	
Capital Stock—Fully Paid	225,000.00
Reserve Fund	45,000.00
Unappropriated Profits	10,000.00
	$320,000.00

On the following May 1, the D Company, Ltd., purchased the business of C Company for $305,000.00. The books of C Company were not closed at the time, and the purchase was based on the Balance Sheet of December 31 last. D Company is to have the right to all profits earned since the date of the Balance Sheet. The necessary entries were made in D Company's books, and Goodwill set up at $25,000.00, the excess of purchase price over the shareholders' equity recorded in the books at the date of the Balance Sheet. When the books were closed at the end of the year the business, which was continued in separate operations, showed a net profit of $30,000.00. Is it in order to appropriate the $30,000.00 for dividends? Earnings had been fairly uniform throughout the year.

Solution. One-third of the year had elapsed when the business of C Company was purchased. If operations were fairly uniform, one-third or $10,000.00 of the profit had been earned prior to May 1. Profits are represented by Assets. From this it follows that when the business of C Company was acquired the net equity was $280,000.00 + (⅓ of $30,000.00 = $10,000.00) or $290,000.00. The excess of purchase price over the net value of tangible assets acquired, or Goodwill value was $15,000.00 instead of $25,000.00. Only $20,000.00 of the profit has been earned since the business was acquired.

When the net profit for the year is determined and brought down, a transfer entry should be made—

Profit and Loss	$10,000.00	
To Goodwill		$10,000.00
To adjust values at time business of C Company was acquired by the amount of profits estimated as earned between the date of the Balance Sheet on which purchase price was based and the date on which the business was acquired.		

This leaves the profit available for distribution, as far as that part of the business is concerned, at $20,000.00.

The Balance Sheet, without regard to any other assets, liabilities, or capital, etc., is as next given.

THE D COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$320,000.00
Sundry—Added by Earnings	30,000.00
Goodwill	15,000.00
	$365,000.00
Liabilities	
Sundry	$40,000.00
Shareholders' Equity—	
Capital Stock—Fully Paid	305,000.00
Unappropriated Profits	20,000.00
	$365,000.00

Adjustments when Interest is Allowed. A further factor enters in if interest is paid by the purchaser from the date of the Balance Sheet, as compensation for earnings between the date of the Balance Sheet and the date the business is acquired.

Problem. Assume the conditions stated in the preceding problem with the addition that D Company agreed to pay interest at 6 per cent. per annum on the purchase price from January 1 to the date of settlement. The D Company plans to issue further shares and pay for the business of C Company in cash. The amount of interest paid to date of settlement was $7,500.00. Make the necessary adjustments at the end of the year. The interest has been charged to Interest Account. Profit was $30,000.00 before interest. Calculate by months.

Solution. Interest at 6 per cent. for four months on $305,000.00 is $6,100.00, calculated by months. Profits before interest were $30,000.00, of which $10,000.00 is estimated as earned by April 30.

The total amount payable at April 30 is $305,000.00 + $6,100.00, or $311,100.00 as $6,100 of the interest is part of the purchase price.

Entries to adjust are—

Goodwill	$6,100.00	
To Interest		$6,100.00
To add to Goodwill, interest on purchase price from January 1 to April 30.		
Profit and Loss	1,400.00	
To Interest		1,400.00
To charge Profit and Loss with interest after April 30 to final settlement.		
Profit and Loss	10,000.00	
To Goodwill		10,000.00
To credit Goodwill with amount added to assets through profits earned from January 1 to April 30.		

The accounts for Profit and Loss and for Goodwill then appear as below—

Dr. *Profit and Loss* *Cr.*

19—					19—				
Dec. 31	To Interest	J.	–	1,400.00	Dec. 31	Balance—			
	,, Goodwill	J.	–	10,000.00		Operating			
	,, Balance—					Profit	J.	–	30,000.00
	Net Profit			18,600.00					
				30,000.00					30,000.00
19—					19—				
Dec. 31	To Appropriation Account	J.	–	18,600.00	Dec. 31	Balance— Net Profit			18,600.00

Dr. *Goodwill* *Cr.*

19—					19—				
May 1	C Company, Ltd.	J.	–	25,000.00	Dec. 31	Profit Adjustment	J.	–	10,000.00
Dec. 31	Interest	J.		6,100.00	Dec. 31	Balance—Cost			21,100.00
				31,100.00					31,100.00
19—									
Jan. 1	Balance—Cost			21,100.00					

The interest after April 30, is interest on borrowed capital, to be treated in the usual manner. It is evident that settlement was not made until a date later than May 1.

This is not a case of writing off Goodwill by a charge to revenue, which would be a wrong procedure. The purpose in this example is to adjust the recorded value from a wrongly stated amount to the correct one, and the

reason the charge is made to Profit and Loss is that profit earning, which added to the assets between January 1 and April 30, made the adjustment necessary.

Amalgamation Through a Syndicate

Amalgamations are frequently brought about through the operations of a syndicate formed for the purpose or through a financial house that specializes in financial ventures of that kind.

The procedure followed is for the syndicate to arrange for the purchase of the shares of the companies that are to be amalgamated, or for the purchase of the business undertakings, and arrange for the formation of a new company to which the business undertakings are sold. Profit for the syndicate must necessarily arise from the difference between the amounts paid to acquire the amalgamating concerns and the amount received from the new company for them. As the consideration received is likely to consist largely of securities of the new company, the amount for which these can be disposed of is also a factor. Aside from the syndicate feature, the accounting entries are very similar to those of a straight amalgamation, as already illustrated. An example, including entries but without setting up the accounts, is given to outline the procedure.

Problem. A syndicate purchased the assets and undertaking of the M Company, Ltd., and of the N Company, Ltd. The consideration of M Company is 8,000 shares of 7 per cent. Preferred stock of $100.00 each, of a new company, the MN Company, Ltd., formed to amalgamate the above two companies, and 20,000 Common shares without par value (MN Company) and $100,000.00 in cash.

For the N Company, Ltd., they are to give 6,000 shares of 7 per cent Preferred stock in the new company, 30,000 Common shares without par value, and $60,000.00 in cash.

The MN Company, Ltd., is formed with an authorized capital of $2,500,000.00 of 7 per cent. Preferred stock and 80,000 shares, Common, without par value. The syndicate sold to the MN Company, Ltd., the assets of each of the two other companies, subject to their liabilities, receiving for M Company, Ltd., 10,000 shares of 7 per cent. preferred stock and 30,000 shares Common. For the N Company, Ltd., they received 8,000 shares of 7 per cent. Preferred and 20,000 Common. The common shares are to be recorded at $10.00 and the full amount credited to capital.

The syndicate undertook the sale of $500,000.00 of the MN Company's unissued preferred, at par, on a commission of 6 per cent. in cash and 10,000 shares without par value. This is carried out, a bonus of one share common being given with each five shares preferred.

The syndicate also sold its own holdings of preferred stock at 98, giving one share of common with each share of preferred, and the balance of the

common shares were disposed of at $8.00 each. The syndicate paid $50,000.00 expenses.

The Balance Sheets of the M and N Companies, as shown by their books, are as given.

THE M COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Cash		$10,000.00
Accounts and Bills Receivable	$100,000.00	
Less Reserve	5,000.00	95,000.00
Stock in Trade		255,000.00
Land		100,000.00
Buildings	350,000.00	
Less Reserve	35,000.00	315,000.00
Plant and Machinery	270,000.00	
Less Reserve	40,000.00	230,000.00
		$1,005,000.00

Liabilities

Accounts Payable	$50,000.00
Bank Loans	100,000.00
Accrued Charges	5,000.00
Capital Stock	600,000.00
Surplus	250,000.00
	$1,005,000.00

THE N COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Cash		$5,000.00
Accounts and Bills Receivable	$85,000.00	
Less Reserve	4,800.00	80,200.00
Stock in Trade		500,000.00
Deferred Charges		4,000.00
Land		80,000.00
Buildings	300,000.00	
Less Reserve	50,000.00	250,000.00
Plant and Machinery	400,000.00	
Less Reserve	80,000.00	320,000.00
Deficit		131,800.00
		$1,371,000.00

Liabilities

Accounts and Bills Payable	$100,000.00
Bank Loans	250,000.00
Accrued Charges	21,000.00
Capital Stock	1,000,000.00
	$1,371,000.00

An appraisal of fixed assets as at December 31, 19— gives further information as to values at that date.

	Land	Buildings	Plant and Machinery
M Company	$125,000.00	$340,000.00	$260,000.00
N Company	100,000.00	275,000.00	350,000.00

(*a*) Raise entries to record the closing out of the M Company, Ltd., and the N Company, Ltd. They each place a value of $10.00 a share on the No Par shares received.

(*b*) Raise the entries necessary to record the transactions in the books of the MN Company, Ltd., and set up the opening Balance Sheet.

(*c*) Raise entries for the above transactions in the books of the syndicate and show the profit or loss.

Realization
1,010,000
250000
1,260000

Solution. (*a*)

(i) Entries to close accounts of the M Company, Ltd.

Reserve for Depreciation—Buildings	$35,000.00	
To Buildings		$35,000.00
Reserve for Depreciation—Plant, etc.	40,000.00	
To Plant and Machinery		40,000.00
Realization Account	1,010,000.00	
To Cash		10,000.00
,, Accounts and Bills Receivable		100,000.00
,, Stock		255,000.00
,, Land		100,000.00
,, Buildings		315,000.00
,, Plant and Machinery		230,000.00
To close Asset Accounts.		
Accounts Payable	50,000.00	
Bank Loans	100,000.00	
Accrued Charges	5,000.00	
Reserve for Bad Debts	5,000.00	
To Realization		160,000.00
Syndicate	1,100,000.00	
To Realization		1,100,000.00
Sale Price.		
Preferred Shares—MN Co., 8,000 at $100.00	800,000.00	
Common Shares—MN Co., 20,000 at $10.00	200,000.00	
Cash	100,000.00	
To Syndicate		1,100,000.00
Consideration received in settlement.		
Capital Stock	600,000.00	
Surplus	250,000.00	
Realization	250,000.00	
To Shareholders		1,100,000.00

1,244,000
91,800
1,335,800

1,335,800

Shareholders	$1,100,000.00	
To Preferred Shares, MN Company		$800,000.00
,, Common Shares, MN Company		200,000.00
,, Cash		100,000.00
Settlement with shareholders.		

(ii) Entries to close accounts of the N Company, Ltd.

Reserve for Depreciation—Buildings	$50,000.00	
To Buildings		$50,000.00
Reserve for Depreciation—Plant, etc.	80,000.00	
To Plant and Machinery		80,000.00
Realization	1,244,000.00	
To Cash		5,000.00
,, Accounts and Bills Receivable		85,000.00
,, Stock		500,000.00
,, Deferred Charges		4,000.00
,, Land		80,000.00
,, Buildings		250,000.00
,, Plant and Machinery		320,000.00
Accounts and Bills Payable	100,000.00	
Bank Loans	250,000.00	
Accrued Charges	21,000.00	
Reserve for Bad Debts	4,800.00	
To Realization		375,800.00
Syndicate	960,000.00	
To Realization		960,000.00
Preferred Shares (6,000), MN Co. at $100.00	600,000.00	
Common Shares (30,000) N.P.V. MN Co. at $10.00	300,000.00	
Cash	60,000.00	
To Syndicate		960,000.00
Consideration received in settlement.		
Capital Stock	1,000.000.00	
Realization	91,800.00	
To Shareholders		1,091,800.00
Shareholders	131,800.00	
To Appropriation (Deficit)		131,800.00

The equity of the shareholders now appears at $1,091,800.00 – $131,800.00 or $960,000.00.

Shareholders	$960,000.00	
To Preferred Shares, MN Company		$600,000.00
,, Common Shares, MN Co.		300,000.00
,, Cash		60,000.00
Settlement with shareholders to close out accounts.		

(*b*) Entries to open the accounts of the MN Company, Ltd.

(i) Taking over business of M Company.

Cash	$10,000.00	
Accounts and Bills Receivable	100,000.00	
Stock	255,000.00	
Land	125,000.00	
Buildings	340,000.00	
Plant and Machinery	260,000.00	
Goodwill	370,000.00	
To Accounts Payable		$50,000.00
,, Bank Loans		100,000.00
,, Accrued Charges		5,000.00
,, Reserve for Bad Debts		5,000.00
,, Syndicate		1,300,000.00

(ii) Taking over business of N Company.

Cash	5,000.00	
Accounts and Bills Receivable	85,000.00	
Stock	500,000.00	
Deferred Charges	4,000.00	
Land	100,000.00	
Buildings	275,000.00	
Plant and Machinery	350,000.00	
Goodwill	56,800.00	
To Accounts and Bills Payable		100,000.00
,, Bank Loans		250,000.00
,, Accrued Charges		21,000.00
,, Reserve for Bad Debts		4,800.00
,, Syndicate		1,000,000.00
Subscribers—Preferred	2,300,000.00	
To Capital Stock—Preferred		2,300,000.00
Amount of issue—Payable in full at once.		
Subscribers—Common	600,000.00	
To Capital Stock—Common		600,000.00
Issue of 60,000 shares N.P.V. At $10.00.		
Syndicate	2,300,000.00	
To Subscribers—Preferred		1,800,000.00
,, Subscribers—Common		500,000.00
Recording issue of shares to Syndicate under purchase agreements.		
Cash	500,000.00	
To Subscribers—Preferred		500,000.00
Commission on Shares	130,000.00	
To Cash		30,000.00
,, Subscribers—Common		100,000.00
Commission allowed to Syndicate.		

An alternative entry would have been to charge Commission and credit Syndicate $100,000.00, and then transfer $2,400,000.00 from Syndicate to credit of Subscribers Preferred $1,800,000.00 and Subscribers Common $600,000.00.

THE MN COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets

Current			
Cash		$485,000.00	
Accounts and Bills Receivable	$185,000.00		
Less Reserve for Bad Debts	9,800.00	175,200.00	
Stock in Trade		755,000.00	$1,415,200.00
Deferred Charges			4,000.00
Fixed			
Land		225,000.00	
Buildings		615,000.00	
Plant and Machinery		610,000.00	1,450,000.00
Commission on Shares			130,000.00
Goodwill			426,800.00
			$3,426,000.00

Liabilities

Current			
Accounts and Bills Payable		150,000.00	
Bank Loans		350,000.00	
Accrued Charges		26,000.00	$526,000.00
Shareholders' Equity—			
Capital Stock—			
Subscribed and Paid, 7% Preferred		2,300,000.00	
Common—60,000 Shares without Par Value. Authorized 80,000 Shares		600,000.00	2,900,000.00
			$3,426,000.00

Had there been Goodwill recorded in the accounts of either or both of the companies taken over, no attention would have been paid to it in the entries of the new company. To it, the amount paid for Goodwill is the excess of the purchase price over the net value of tangible assets acquired, and it is not concerned about any Goodwill recorded in the books of the other companies.

The MN Company could have omitted Goodwill by recording the No Par Value Common at $173,200.00 only. Again, under some existing legislation, it may have credited to Capital only a small part of the consideration value given as received for Common and from the Capital Surplus created could have written off the Goodwill and Commission on shares.

No entries are made in the financial books to record shares given as a bonus with Preferred. These are shares already issued to and given as a bonus by the syndicate. The transaction affects the transfer books and share ledger only.

(*c*) Entries in the books of the syndicate.

The syndicate need not record the individual assets and liabilities, but may treat each company's undertaking as a unit.

Business of M Company, Ltd.	$1,100,000.00	
To M Company, Ltd.		$1,100,000.00
To record purchase.		
Business of N Company, Ltd.	960,000.00	
To N Company, Ltd.		960,000.00
To record purchase.		
The MN Company, Ltd.	2,300,000.00	
To Business of M Company		1,300,000.00
,, Business of N Company		1,000,000.00
Sale of business to MN Company.		
Preferred Shares—MN Company (18,000)	1,800,000.00	
Common Shares—MN Company (50,000)	500,000.00	
(Shares without par value)		
To MN Company, Ltd.		2,300,000.00
MN Company, Ltd.	130,000.00	
To Commission		130,000.00
Common Shares—MN Company (10,000) N.P.V.	100,000.00	
Cash	30,000.00	
To MN Company, Ltd.		130,000.00
M Company, Ltd.	1,100,000.00	
To Preferred Shares—MN Company		800,000.00
,, Common Shares—MN Company		200,000.00
,, Cash		100,000.00
Settlement of purchase—8,000 shares preferred and 20,000 shares common and $100,000.00 cash.		
N Company, Ltd.	960,000.00	
To Preferred Shares—MN Company		600,000.00
,, Common Shares—MN Company		300,000.00
,, Cash		60,000.00
Consideration given—6,000 shares preferred, 30,000 shares common, and $60,000.00 cash.		

The syndicate received 18,000 shares Preferred and gave out 14,000 so has 4,000 on hand. These are sold at 98. They received 60,000 shares Common, gave out 50,000 in connection with the purchase, and gave 1,000 shares as a bonus so have only 9,000 shares on hand. These are sold at $8.00.

Bonus given	$10,000.00	
To Common Shares—MN Company		$10,000.00
Cash	464,000.00	
To Preferred Shares—MN Company		392,000.00
,, Common Shares—MN Company		72,000.00
Disposal of shares on hand.		
Expenses	50,000.00	
To Cash		50,000.00
Business of M Company, Ltd.	200,000.00	
Business of N Company, Ltd.	40,000.00	
Commission	130,000.00	
To Profit and Loss		370,000.00
Profit and Loss	60,000.00	
To Expenses		50,000.00
,, Bonus given		10,000.00
Profit and Loss	26,000.00	
To Preferred Shares—MN Company		8,000.00
,, Common Shares—MN Company		18,000.00

LEDGER

Dr. *Business of M Company, Ltd.* *Cr.*

19—					19—				
Jan.	1	To M Company	J. –	1,100,000.00	Jan.	1	By MN Company	J. –	1,300,000.00
Jan.	1	Profit and Loss	J. –	200,000.00					
				1,300,000.00					1,300,000.00

Dr. *Business of N Company, Ltd.* *Cr.*

19—					19—				
Jan.	1	To N Company	J. –	960,000.00	Jan.	1	By MN Company	J. –	1,000,000.00
Jan.	1	Profit and Loss	J. –	40,000.00					
				1,000,000.00					1,000,000.00

Dr. *Preferred Shares—MN Co.* *Cr.*

19—					19—				
Jan.	1	M & N Companies, 18,000 Shares	J. –	1,800,000.00	Jan.	1	M Company, 8,000 Shares	J. –	800,000.00
							N Company, 6,000 Shares	J. –	600,000.00
							Cash, 4,000 Shares	C. –	392,000.00
							Profit and Loss	J. –	8,000.00
				1,800,000.00					1,800,000.00

Common Shares—MN Co.

Dr.					Cr.				
19—					19—				
Jan.	1	MN Company, 50,000 Shares	J. –	500,000.00	Jan. 1	M Company, 20,000 Shares	J. –	$200,000.00
		MN Company, 10,000 Shares	J. –	100,000.00		N Company, 30,000 Shares	J. –	300,000.00
						Bonus, 1,000 Shares	J. –	10,000.00
						Cash, 9,000 Shares	J. –	72,000.00
						Profit and Loss		18,000.00
				600,000.00				600,000.00

M Company, Ltd.

Dr.				Cr.			
19— Jan. 1	Settlement	J. –	1,100,000.00	19— Jan. 1	Business Acquired	J. –	1,100,000.00

N Company, Ltd.

Dr.				Cr.			
19— Jan. 1	Settlement	J. –	960,000.00	19— Jan. 1	Business Acquired	J. –	960,000.00

Bonus Given

Dr.				Cr.			
19— Jan. 1	1,000 Shares given	J. –	10,000.00	19— Jan. 1	Profit and Loss	J. –	10,000.00

Expenses

Dr.					Cr.				
19—					19—				
Jan. 1	Payment	C.	–	50,000.00	Jan. 1	Profit and Loss	J.	–	50,000.00

Profit and Loss

Dr.					Cr.				
19—					19—				
Jan. 1	Bonus	J.	–	10,000.00	Jan. 1	M Company, Business	J.	–	200,000.00
	Expenses	C.	–	50,000.00		N Company, Business	J.	–	40,000.00
	Preferred Shares	J.	–	8,000.00		Commission	J.	–	130,000.00
	Common Shares	J.	–	18,000.00					
	Balance—Net Profit			284,000.00					
				370,000.00					370,000.00
					Jan. 1	Balance—Net Profit			284,000.00

Cash

Dr.					Cr.				
19—					19—				
Jan. 1	Preferred Shares	C.	–	392,000.00	Jan. 1	M Company, Purchase	C.	–	100,000.00
	Common Shares	C.	–	72,000.00		N Company, Purchase	C.	–	60,000.00
	Commission	C.	–	30,000.00		Expenses	C.	–	50,000.00
						Balance			284,000.00
				494,000.00					494,000.00
Jan. 1	Balance			284,000.00					

The accounts submitted, and based on the entries given, indicate that when the syndicate had completed the venture there was a net profit of $284,000.00, the full amount of which is represented by cash.

At any time before completion of the venture the accounts of the syndicate would show shares still on hand and a higher paper profit, but unless the shares themselves are distributed among the members of the syndicate, the division at any time should not be for an amount greater than the cash on hand available after providing for expenses.

No account is necessary for the bonus given, except that it serves as a check on the disposition of the shares and makes the records more complete, since the shares have been recorded at a certain figure when received.

Alternative Method. In the above example it is assumed that the syndicate purchased the business of each of the companies to be amalgamated and their records show a sale to the syndicate.

The syndicate may have purchased the shares of these companies as a first step. When the sale to the MN Company, Ltd., is effected, the entries in the books of the M Company and of the N Company would record the sale to the MN Company in a manner similar to that illustrated in the case of the X Company, Ltd., and the Y Company, Ltd., sold to the Z Company, Ltd.

Syndicate entries would at first record the purchase of the shares—

Shares in M Company, Ltd.	$1,100,000.00	
To 7% Preferred Shares of MN Company, Ltd. (8,000)		$800,000.00
,, Common Shares, MN Company, Ltd., 20,000 N.P.V.		200,000.00
,, Cash		100,000.00
Shares in N Company, Ltd.	960,000.00	
To 7% Preferred Shares of MN Company, Ltd. (6,000)		600,000.00
,, Common Shares, MN Company, Ltd., 30,000 N.P.V.		300,000.00
,, Cash		60,000.00

This sale does not affect the M Company, Ltd., and the N Company, Ltd., as entities. There is merely a change in the holders of shares. These companies then sell their undertakings to the MN Company, Ltd. While the syndicate does not appear in the entries recording the sale and purchase, it is the syndicate which, owning all the shares in the two companies, receives the consideration as shareholders.

Absorption by Purchase of Shares

Should one company desire to obtain control of another company without destroying the identity of the company acquired, the procedure involves only the purchase of the shares of the company acquired.

Problem. The Alpha Company, Ltd., purchased the outstanding shares of The Beta Company, Ltd., for $600,000.00. The consideration given was the issue of 6,000 shares, $100.00 each, in return for 5,000 shares of The Beta Company, Ltd., which were transferred by the holders to The Alpha Company, Ltd. The Balance Sheet of The Beta Company, Ltd., shows a shareholders' equity of $560,000.00 represented by $500,000.00 Paid-up Capital Stock, $50,000.00 Reserve Fund, and $10,000.00 unappropriated profits.

(*a*) Record the transaction in the books of The Alpha Company, Ltd.

(*b*) What record will be made in the books of The Beta Company, Ltd.?

Solution. (*a*) Entries to record the transaction in the books of The Alpha Company, Ltd.—

Subscribers	$600,000.00	
To Capital Stock		$600,000.00
Shares in The Beta Company, Ltd.	600,000.00	
To Subscribers		600,000.00

This records the issue of 6,000 shares and the consideration received. The investment is recorded at the amount paid for it, and the fact that this is above par or an amount greater than the equity recorded in the books of the other company does not enter into the matter. The Goodwill feature appears only when a consolidated statement of the two companies is prepared, a subject that will be dealt with under Holding Companies.

(*b*) There are no entries to be made in the financial books of The Beta Company, Ltd. Its position is not in any way affected as far as continuing as a separate entity is concerned. In the transfer book and share ledger entries will be made to record the transfer of shares from the former holders to the new, The Alpha Company, Ltd.

CHAPTER SIXTEEN

HOLDING COMPANIES

Holding Company Explained. A Holding Company is one which holds a controlling interest in one or more other companies, through the purchase of all or of a majority interest in the shares of those companies. This controlling interest places the Holding Company in a position to control the policies of the other companies in which the controlling interest is held.

As this places the companies so controlled in a position subsidiary to the Holding Company, the controlled companies are referred to as Subsidiary Companies.

The controlling interest is usually obtained through the issue of the shares, and possibly bonds, of the Holding Company in exchange for those of the other companies, but there are cases where the Holding Company issues its own securities for cash and applies the cash to the purchase.

Each subsidiary retains its own identity as a separate corporation, the only change being in the holders of its shares. The Holding Company, however, through the control it holds, has the power to elect the board of directors and to determine the business policy of the subsidiaries.

From these facts it is apparent that the result is a complete combination. To all intents and purposes the Holding Company and its subsidiaries constitute one great corporation, although in fact the combination is composed of a number of separate entities. Competition is brought under control, if such has existed, and each company may be conducted in the interests of the combination as a whole.

There is a distinction between a Holding Company and a Parent Company, although one company may be both. A company that has acquired a controlling interest in other already existing companies is a Holding Company but not a Parent Company. On the other hand, a company that organizes a new company which it controls is both a Parent Company and a Holding Company.

The purpose of such combination is not necessarily to control competition. A usual purpose is to bring under one control a number of companies whose operations are more or less co-related. An example in point is the Dominion Steel and Coal Corporation, Ltd., in Nova Scotia, which controls, directly or through subsidiary holding companies, Dominion Iron & Steel Company, Ltd., Nova Scotia Steel & Coal Company, Ltd., James Pender & Company, Ltd., Peck Rolling Mills, Ltd., Eastern Car Company, Ltd., Halifax Shipyards, Ltd., Dominion Shipping Company, Ltd., Sydney & Louisburg

Railway Company, Ltd., Dominion Coal Company, Ltd., Acadia Coal Company, Ltd., Security Fence Company, Ltd., and St. Lawrence Wire Company, Ltd. These companies operate industries that are naturally related to each other and, with unified control, this relation can be developed to the best mutual advantage. Many other examples are afforded in Canada by combinations of this kind. In some instances a first holding company controls one or more subsidiaries which in turn control companies subsidiary to them. For example, The Standard Oil Company of New Jersey controls Imperial Oil, Limited, which in turn, controls the International Petroleum Corporation. Or again, The International Paper and Power Company controls International Hydro-Electric System, which controls Canadian Hydro-Electric Corporation, Ltd., and it, in turn, controls the Gatineau Power Company, Ltd.

In addition to control of subsidiaries there may be minority interests held by the Holding Company in still other companies. The Dairy Corporation of Canada controls the Edmonton City Dairy, Ltd.; City Dairy, Ltd., Winnipeg; Purity Dairy Company, Regina; Purity Ice Cream Company, Winnipeg; Davis Dairy Company, Saskatoon; Canada Dairies, Ltd., Toronto; Montreal Dairy Company, Ltd., Montreal; and, besides, holds a minority interest in a number of other but similar companies which it does not control.

Factors Affecting Financial Statements

The Holding Company records its investment in other companies at cost and in its own Balance Sheet such amounts appear as investments in other companies. As the other companies are also entities apart from the Holding Company, each prepares its own Balance Sheet, in which the capital stock owned by the Holding Company appears in the usual way. It is not affected in any way by the shares being held as they are.

The real value of the shares depends largely on the net assets behind them and these assets are recorded only in the accounts of the subsidiary Corporation. The Balance Sheet of the Holding Company alone does not give all the desired information relative to the combination as a whole. To get this a consolidated Balance Sheet of all the companies is necessary. The consolidated Balance Sheet is the financial statement of the whole undertaking.

In preparing the consolidated Balance Sheet a number of points may arise, and the correctness of the statement depends on their proper treatment.

Capital Stock. The Capital Stock of subsidiary companies, owned by the Holding Company, is eliminated from the consolidated Balance Sheet, but that held by outside (minority) interests is included. The reason is, that the capital stock of a subsidiary company owned by a Holding Company is represented by the issue of shares of the Holding Company made at the time of purchase, and the amount is thus already included in the Holding Company's capital stock. The assets were not increased by the exchange of

shares. The former shareholders of the subsidiary company received shares in the Holding Company, and gave to the Holding Company the shares they held in the subsidiary. There cannot then be two issues of Capital Stock for the same asset values.

If the Holding Company purchased the shares of the subsidiary company for Cash or other assets, there would be a transfer of assets between two companies within the same consolidation, but no addition to consolidated assets. The amount paid under either method is the accepted value of the subsidiary or the portion of its equity acquired. The capital stock of the Holding Company is at least partially applied to the purchase, and in consolidating the statements the capital stock of the subsidiary thus acquired will not again appear.

The minority interest in subsidiaries must be shown, as the equity of the minority is distinct from that of the Holding Company, and the consideration came from outside the consolidation.

A minority interest held by the Holding Company in other companies appears in the Balance Sheet as an asset "Investments in other Companies." The assets behind these shares are not within the consolidation, and, of course, are not included in the Balance Sheet.

Frequently, companies within the consolidation own shares, each in the others. The moving around of assets within the consolidation, as consideration for shares of companies also within the consolidation, does not increase the assets, nor does it increase the capital stock issued to the public. Only capital stock issued and held outside of the consolidation will appear as the capital stock issued by the consolidation.

Problem. Following are the Balance Sheets (condensed) of A Company, Ltd., and of B Company, Ltd., as at December 31, 19—.

Company A owns 90 per cent. of the shares of Company B, and Company B owns 10 per cent. of the shares of Company A.

Prepare a consolidated Balance Sheet.

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$780,000.00
Investment in Company B	360,000.00
	$1,140,000.00
Liabilities	
Sundry	$40,000.00
Capital Stock—Fully Paid	1,100,000.00
	$1,140,000.00

B COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry	$320,000.00
Investment in Company A	110,000.00
	$430,000.00

Liabilities

Sundry	$30,000.00
Capital Stock—Fully Paid	400,000.00
	$430,000.00

Solution—

A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
December 31, 19—

Assets

Sundry	$1,100,000.00
	$1,100,000.00

Liabilities

Sundry		$70,000.00
Capital Stock—A	$1,100,000.00	
Less owned by B	110,000.00	
	990,000.00	
Held by Minority Interests in B	40,000.00	1,030,000.00
		$1,100,000.00

Problem. Assuming that Company A owned all the shares of Company B, and that B held none of Company A shares, with Balance Sheets as below, prepare a Consolidated Balance Sheet.

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry	$740,000.00
Shares in Company B	400,000.00
	$1,140,000.00

Liabilities

Sundry	$40,000.00
Capital Stock—Fully Paid	1,100,000.00
	$1,140,000.00

B COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry	$430,000.00
	$430,000.00

Liabilities

Sundry	$30,000.00
Capital Stock—Fully Paid	400,000.00
	$430,000.00

Solution.

A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
December 31, 19—

Assets

Sundry	$1,170,000.00
	$1,170,000.00

Liabilities

Sundry	$70,000.00
Capital Stock—Fully Paid	1,100,000.00
	$1,170,000.00

Bonds. Should the Holding Company own bonds issued by the subsidiary company, or *vice versa*, those owned within the consolidation will not appear as a liability, but those held by the public will so appear. The bonds of the companies held within the consolidation itself represent the investment of capital already recorded, and on the due date of the bonds no funds will need to be paid outside the consolidation. It is a matter between the companies themselves and the public are not concerned.

Problem. Following are the Balance Sheets of A Company, Ltd., and of B Company, Ltd., at December 31, 19—. Prepare a Consolidated Balance Sheet. Company A owns all the shares of B and 40 per cent. of the bonds issued by B. Company B owns 20 per cent. of the bonds issued by Company A.

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry	$740,000.00
Bonds of Company B	80,000.00
Shares in Company B	400,000.00
	$1,220,000.00

Liabilities

Sundry	$40,000.00
Bonds Payable	500,000.00
Capital Stock—Fully Paid	680,000.00
	$1,220,000.00

B COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry	$530,000.00
Bonds—Company A	100,000.00
	$630,000.00

Liabilities

Sundry	$30,000.00
Bonds Payable	200,000.00
Capital Stock—Fully Paid	400,000.00
	$630,000.00

Solution.

A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
December 31, 19—

Assets

Sundry		$1,270,000.00
		$1,270,000.00

Liabilities

Sundry		$70,000.00
Bonds Payable, A	$500,000.00	
Less Held by B	100,000.00	400,000.00
Bonds—Company B	200,000.00	
Less Held by A	80,000.00	120,000.00
Capital Stock—Fully Paid		680,000.00
		$1,270,000.00

From the above it is apparent that in preparing a Consolidated Balance Sheet of a Holding Company and its subsidiaries, the object is to portray the relation of the whole consolidation to the public.

Surplus at Date of Purchase. If, when the Holding Company acquired a subsidiary, the accounts of the latter recorded a surplus, that surplus (of the subsidiary) does not appear in a consolidated Balance Sheet prepared later, but surplus earned since that date does appear.

The reason for this lies in the fact that the capital and surplus of the company whose shares are acquired are represented by assets in excess of liabilities, and the consideration given by the Holding Company in the purchase is for the accepted value of the equity in the assets and represented in the amount of Capital Stock Paid-up plus surplus, together with any further amount paid for Goodwill. The whole net value is covered by Capital Stock issued by the Holding Company if shares are issued in settlement. If other consideration is given the full value is covered by that consideration, so that, as the subsidiary acquired comes into the consolidation only at the time of purchase, it cannot have earned profits for the consolidation before

that time. The Balance Sheet of the subsidiary is not affected by the purchase and the surplus continues to appear in its accounts and Balance Sheet. Should dividends be declared from that surplus and paid to the Holding Company, the latter should credit its investment in subsidiary company shares with the amount, and not treat the dividend as revenue. The dividend received by the Holding Company out of the surplus earned by a subsidiary before it became such constitutes a return of part of the value purchased.

Problem. Following are the Balance Sheets of A Company, Ltd., and of B Company, Ltd., at December 31, 19—. At that date Company A purchased all the shares of Company B.

(*a*) Prepare a consolidated Balance Sheet as after the purchase, assuming that Company A issues $265,000.00 in its own shares at par in settlement.

(*b*) Prepare a consolidated Balance Sheet as after the purchase if Company A paid cash for the shares of Company B, the purchase price being $265,000.00.

(*c*) Prepare a Consolidated Balance Sheet as after the purchase, assuming Company A paid $290,000.00 for the shares of Company B, and issued its own shares in settlement.

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$1,250,000.00
	$1,250,000.00
Liabilities	
Sundry	$50,000.00
Capital—Fully Paid	1,000,000.00
Reserve Fund	175,000.00
Unappropriated Profits	25,000.00
	$1,250,000.00

B COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$295,000.00
	$295,000.00
Liabilities	
Sundry	$30,000.00
Capital—Fully Paid	200,000.00
Reserve Fund	55,000.00
Unappropriated Profits	10,000.00
	$295,000.00

Solution. (*a*)

A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$1,545,000.00
	$1,545,000.00
Liabilities	
Sundry	$80,000.00
Capital Stock—Fully Paid	1,265,000.00
Reserve Fund	175,000.00
Unappropriated Profits	25,000.00
	$1,545,000.00

(*b*)

A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$1,280,000.00
	$1,280,000.00
Liabilities	
Sundry	$80,000.00
Capital Stock—Fully Paid	1,000,000.00
Reserve Fund	175,000.00
Unappropriated Profits	25,000.00
	$1,280,000.00

(*c*)

A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$1,545,000.00
Goodwill	25,000.00
	$1,570,000.00
Liabilities	
Sundry	$80,000.00
Capital Stock—Paid Up	1,290,000.00
Reserve Fund	175,000.00
Unappropriated Profits	25,000.00
	$1,570,000.00

In the above examples the surplus of Company B at the time it is acquired by Company A is eliminated, and the surplus in the Consolidated Balance Sheet is that of A alone.

Goodwill. The Goodwill recorded in the books of a company before it is acquired by a Holding Company does not necessarily enter into a consolidated statement. The Goodwill in a consolidated statement is the excess of the purchase price over the net tangible value behind the shares acquired. In the last example Goodwill is shown in the consolidated statement, although it does not appear in the accounts of either of the companies. In the books of Company A the investment in shares in Company B is recorded at $290,000.00 the amount paid for the shares, without any reference to Goodwill. Had the assets of Company B included Goodwill, $15,000.00, the amount in the consolidated Balance Sheet would have been $40,000.00. The same would have been true had there been Goodwill, $15,000.00, recorded in the books of Company A.

Inter-Company Accounts. Amounts due to the Holding Company by the subsidiary companies are omitted from the consolidated Balance Sheet. Amounts due by one subsidiary company to another, or by the Holding Company to a subsidiary, are also omitted.

These are inter-company transactions, and when such appear as Amounts Receivable in the accounts of one company they also appear as Amounts Payable in the accounts of the other company affected. One thus offsets the other. Inter-company amounts do not add to the amounts receivable from the public, nor do they increase the amount payable to the public by the whole consolidation. These are *bona fide* assets and liabilities in the Balance Sheets of the individual companies, but they do not affect the relation of the whole organization to the public.

In the Balance Sheets of the individual companies amounts owing by or to other companies within the consolidation are better shown separate from ordinary trade accounts and Bills Receivable or Payable. When settlement is made the amount of net assets of the whole organization is not affected, nor is the total amount of assets.

Inter-Company Bills Receivable Under Discount. Ordinarily, when Bills Receivable are discounted, no reference is made to them in a Balance Sheet since there is no direct liability. A footnote to the Balance Sheet states the amount of contingent liability. The expectation is that the primary debtor will pay the bill and the matter will be closed. If he does not, and amounts are charged back, a charge is made to the account of the defaulting debtor and an asset thus set up.

A different situation exists when bills drawn between a Holding Company and a subsidiary, or between two subsidiaries, are discounted. Regardless of who pays the bill to the bank when it falls due, the consolidated current assets are reduced, because both drawer and acceptor are within the consolidation. From this it follows that when such inter-company bills are discounted the amount must appear in the Consolidated Balance Sheet as a current liability. The entries in the books of the separate companies are the same as in ordinary cases. Attention is here drawn not to the separate companies but to the consolidation and the Balance Sheet of the whole organization.

Advances by Holding Company to Subsidiary. Advances made to a subsidiary company by the Holding Company do not appear in a Consolidated Balance Sheet, although they do appear in the Balance Sheets of the separate companies. The relation is similar to that discussed under Accounts and Bills Receivable. If the advances are made to enable the subsidiary to acquire fixed or other assets and not because of need for working capital, when such need is caused by losses, no further consideration is necessary.

It is sometimes claimed that if the need is for working capital because of losses, a reserve should be set up in the accounts of the Holding Company against the advance, but if losses have been sustained which have impaired the value of the investment in shares of the subsidiary company, the reserve should be set up against the original investment rather than against the advance which at the time is in the form of sound assets. To the extent that there is doubt as to the future and the security of the advance, a reserve, however, should be set up.

Summary. From the discussion of the features so far dealt with, it becomes clear that purely inter-company assets and liabilities are eliminated from the Consolidated Balance Sheet, but that all amounts affecting the relations of the consolidation to the public must be included.

Inter-Company Profits. The individual companies within the consolidation are separate legal entities each from the other, and may enter into contracts with each other just as they may with outside concerns. These transactions in so far as they affect buying and selling goods or services will be carried out with a view to profit by the selling companies, and to them this is a legitimate profit to be recorded by them in the usual manner. In so far as goods purchased from another company within the consolidation have been sold to the public no question arises, but if such goods are in the hands of the purchasing company at the date the accounts are closed and a Balance Sheet is prepared special consideration is necessary.

in the value of

Profits are represented by an increase in assets. This applies from the point of view of the selling company, but it does not apply to the organization as a whole when goods are sold by one unit of the organization to another unit in the same organization, and a sale to the public by the latter has not taken place.

When preparing a Balance Sheet of the whole consolidation there will be eliminated from the value of assets on hand the amount of inter-company profit included in the inventory value, and a like amount must be taken out of the consolidated earned surplus. The organization as a whole cannot earn profits available for distribution to the shareholders of the Holding Company through transactions between units within it. In other words, a business organization cannot earn profits for shareholders through transactions wholly within itself.

The problem that follows has incorporated within it some of the features that have been subject to discussion.

Problem. The A Company, Ltd., owns 90 per cent. of the Capital Stock of the B Company, Ltd. This was acquired on January 1, 19—, and you are asked to prepare a Consolidated Balance Sheet as at December 31, 19— (the same year).

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Cash in Bank	$8,000.00
Accounts Receivable	50,486.00
Bills Receivable	75,218.00
Stock in Trade	147,680.00
Advances to B	55,000.00
Sinking Fund Investment	20,000.00
Land	30,000.00
Buildings	72,950.00
Plant and Machinery	116,847.00
Furniture and Equipment	18,212.00
Goodwill	40,000.00
Investment in B	280,000.00
	$914,393.00
Liabilities	
Accounts Payable	$37,629.00
Bills Payable	51,741.00
Bank Loan	60,000.00
Accrued Charges	1,200.00
Mortgage Bonds—6%	80,000.00
Sinking Fund Reserve	20,000.00
Capital Stock	400,000.00
Surplus	263,823.00
	$914,393.00

Contingent Liability, Bills Under Discount, $40,000.00. 320

B COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Cash in Bank	$5,000.00
Accounts Receivable	31,219.00
Bills Receivable	42,691.00
Stock in Trade	93,620.00
Investment—Bonds of A	50,000.00
Land	25,000.00
Buildings	88,000.00
Plant and Machinery	87,614.00
Equipment	2,870.00
Goodwill	25,000.00
	$451,014.00

Continued on next page

Liabilities	
Accounts Payable	$18,697.00
Bills Payable	26,417.00
Bank Loans	31,500.00
A Company, Ltd.	55,000.00
Mortgage	30,000.00
Capital Stock	200,000.00
Surplus	89,400.00
	$451,014.00

Contingent Liability, Bills Under Discount, $38,000.00.

On an examination of the accounts it is found—

(*a*) The B Company contracted for new buildings for the A Company at a price of $40,000.00, the cost to B being $32,000.00. They were completed during the year.

(*b*) Company B's inventory includes goods bought from A at $20,000.00, the cost to A being $16,000.00.

(*c*) At January 1, 19—, the surplus of A was $180,000.00, and that of B $63,400.00. During the year B paid 7 per cent. dividends out of surplus as at January 1, 19—. Company A credited the amount received to its surplus.

(*d*) Of bills under discount by A, $8,000.00 are bills drawn on B, and of B's bills under discount, $20,000.00 are bills drawn on A.

(*e*) Of A's Bills Receivable, $15,000.00 were drawn on B and of B's Bills Receivable, $10,000.00 were drawn on A. These are in addition to those discounted.

Solution. When preparing a consolidated Balance Sheet of a Holding Company and its subsidiaries, it is desirable that a working Balance Sheet be first prepared, showing eliminations and indicating how the final consolidated Balance Sheet is obtained.

Assets	A Company, Ltd.	B Company, Ltd.	Eliminations etc.	Consolidated
Cash	$8,000.00	$5,000.00		$13,000.00
Accounts Receivable	50,486.00	31,219.00		81,705.00
Bills Receivable	75,218.00	42,691.00	$25,000.00	92,909.00
Stock in Trade	147,680.00	93,620.00	4,000.00	237,300.00
Advances to Company B	55,000.00		55,000.00	
Sinking Fund Investment	20,000.00			20,000.00
Land	30,000.00	25,000.00		55,000.00
Buildings	72,950.00	88,000.00	7,200.00	153,750.00
Plant and Machinery	116,847.00	87,614.00		204,461.00
Furniture and Equipment	18,212.00	2,870.00		21,082.00
Investment in B	280,000.00 – 12,600.00		280,000.00 – 12,600.00	
Investment—A Bonds		50,000.00	50,000.00	
Goodwill	40,000.00	25,000.00		2,500.00 105,440.00
	$914,393.00	$451,014.00		$987,147.00

Note. Refer to statement showing amount of goodwill following the Consolidated Balance Sheet.

Continued on next pag

Liabilities, etc.	A Company, Ltd.	B Company, Ltd.	Eliminations, etc.	Consolidated
Accounts Payable	$37,629.00	$18,697.00		$56,326.00
Bills Payable	51,741.00	26,417.00	$25,000.00	53,158.00
Bank Loans	60,000.00	31,500.00		91,500.00
A Company Ltd.		55,000.00	55,000.00	
Accrued Charges	1,200.00			1,200.00
Mortgage Bonds	80,000.00		50,000.00	30,000.00
Mortgage		30,000.00		30,000.00
Capital Stock	400,000.00	200,000.00	180,000.00	420,000.00
			Minority	20,000.00
Surplus	263,823.00	89,400.00	44,460.00	276,023.00
	−12,600.00		7,200.00	
			4,000.00	
			Minority	8,940.00
Sinking Fund Reserve	20,000.00			20,000.00
	$914,393.00	$451,014.00		$987,147.00

From the "Consolidated" columns, the information is provided for the Consolidated Balance Sheet.

The amount of surplus eliminated is accounted for by the fact that B's surplus at January 1 amounted to $63,400.00, of which the minority interest is 10 per cent. or $6,340.00. This leaves $57,060.00. Out of this a dividend of $12,600.00 was declared and credited by Company A to surplus. $57,060.00 −$12,600.00 leaves $44,460.00, and in addition $12,600.00 must be eliminated, as it was part of the surplus when Company A acquired control of Company B.

The further item eliminated, $7,200.00, is the amount of inter-company profit on assets still on hand. This is true also of the item $4,000.00.

See also later statement of surplus.

THE A COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet

December 31, 19—

Assets

Current		
Cash in Bank	$13,000.00	
Accounts Receivable	81,705.00	
Bills Receivable	92,909.00	
Stock in Trade	237,300.00	$424,914.00
Fixed		
Land	55,000.00	
Buildings	153,750.00	
Plant and Machinery	204,461.00	
Furniture and Equipment	21,082.00	434,293.00
Goodwill		107,940.00
Investment		
Sinking Fund—Cash and Securities		20,000.00
		$987,147.00

Continued on next page

Liabilities

Current			
Accounts Payable		$56,326.00	
Bills Payable		53,158.00	
Bank Loans		91,500.00	
Accrued Charges		1,200.00	$202,184.00
Fixed or Deferred			
Mortgage Bonds		80,000.00	
Less Owned by Subsidiary Company		50,000.00	
		30,000.00	
Mortgage		30,000.00	60,000.00
Shareholders' Equity			
Capital Stock—Subscribed and Paid		400,000.00	
Capital Stock—Minority Interest		20,000.00	
		420,000.00	
Surplus	$276,023.00		
Surplus—Minority Interest	8,940.00	284,963.00	
Sinking Fund Reserve		20,000.00	724,963.00
			$987,147.00

Contingent Liability, Bills under Discount $25,000.00. (50,000)

The supplementary statements that follow are intended to explain how some of the amounts in the Consolidated Balance Sheet are arrived at, and in reviewing these reference should be made also to the explanatory discussion that precedes the problem.

Goodwill. A Company, Ltd., purchased 90 per cent. of the shares of B Company, Ltd., when B Company's tangible equity was represented by

Capital Stock	$200,000.00	
Surplus	63,400.00	
	263,400.00	
Less Goodwill	25,000.00	
	238,400.00	
90% of $238,400.00 is		$214,560.00
For which A Company Paid		280,000.00
Paid for Goodwill		65,440.00
Minority Interest, 1/10th B's Goodwill of $25,000.00		2,500.00
A's Goodwill		40,000.00
Total Consolidated Goodwill Value		$107,940.00

or

B's Equity, Jan. 1, per Balance Sheet	$263,400.00	
90%, representing A's Purchase, 90% of $263,400.00		$237,060.00
For which A paid		280,000.00
Paid for Goodwill in excess of B's Goodwill of $25,000		42,940.00
A's Goodwill per Balance Sheet		40,000.00
B's Goodwill per Balance Sheet		25,000.00
Total Goodwill, Consolidated		$107,940.00

Bills Receivable and Payable. Of A's Bills Payable, $30,000.00 are in favour of B, and of B's Bills Payable, $23,000.00 are in favour of A. Of this total, $53,000.00, $28,000.00 is for Bills Discounted, so that this amount has been cleared from the Bills Receivable of A, $8,000.00, and of B, $20,000.00. The remaining $25,000.00 are eliminated in preparing the Consolidated Balance Sheet, as they are inter-company items. This amount $25,000.00 is eliminated from Bills Payable for the same reason. A's Bills Receivable drawn on B are Bills Payable to B, and B's Bills Receivable drawn on A are Bills Payable to A. The $28,000.00 under discount still appear as Bills Payable, $8,000.00 in B's books, and $20,000.00 in A's books and are not eliminated when preparing the Consolidated Balance Sheet because, whether A pays those it accepted or leaves them to be charged back to B, and whether B pays those it accepted or leaves them to be charged back to A, the fact remains that $28,000.00 of the consolidated assets must be paid over the discounting bank in settlement. These are active Bills Payable to the consolidation.

Statement of Surplus. The surplus in the Balance Sheet is divided into two sections so that the equity of the minority interest and that of the Holding Company and subsidiary may be separately stated.

The minority interest is represented by $6,340.00, or 10 per cent of B's surplus at January 1, plus $4,000.00 or 10 per cent of B's profit for the current year, less dividend of 7 per cent on $20,000.00 or $1,400.00, thus making $6,340.00 + $4,000.00 or $10,340.00 – $1,400.00 or $8,940.00.

Consolidated surplus of the Holding Company and its 90 per cent. interest in B Company is arrived at as follows—

A's Surplus, January 1		$180,000.00
A's Profit for Year	$83,823.00	
Less Dividend credited to Surplus	12,600.00	71,223.00
B's Profit for Year	40,000.00	
Deduct Minority Portion	4,000.00	36,000.00
		287,223.00
Less Inter-Company Profit—Buildings	7,200.00	
Inter-Company Profit—Inventory	4,000.00	11,200.00
Consolidated Surplus		$276,023.00

These calculations, except that of dividend to A out of B's surplus, when interest was acquired, do not come into the accounts of either company, but arise only in preparing consolidated statements. The surplus of the individual companies, with the above exception, are as shown in their own Balance Sheets.

This calculation is made without confusing the Sinking Fund Reserve of Company A which, as shown in the Consolidated Balance Sheet, represents a part of the surplus.

Deficit of Subsidiary Company Acquired

If a Holding Company has acquired the shares of a subsidiary when the latter has a deficit, the deficit is cleared for reasons similar to those applied when there was a surplus. The book value of the net assets behind the shares is the Paid-up Capital less the Deficit.

Problem. The Balance Sheets of E Company, Ltd., and of F Company, Ltd., as at January 1, 19—, are as given below.

At this date Company E acquires all the shares of Company F by issuing its own shares for $255,000.00.

Prepare a Consolidated Balance Sheet as after the purchase has been put into effect.

E COMPANY, LTD.

Balance Sheet
January 1, 19—

	Assets	
Sundry		$800,000.00
		$800,000.00
	Liabilities and Capital	
Sundry Creditors		$60,000.00
Capital Stock—Fully Paid		600,000.00
Surplus		140,000.00
		$800,000.00

F COMPANY, LTD.

Balance Sheet
January 1, 19—

	Assets	
Sundry		$280,000.00
		$280,000.00
	Liabilities and Capital	
Sundry Creditors		$25,000.00
Capital Stock—Fully Paid	$290,000.00	
Deduct Deficit	35,000.00	
Shareholders' Equity		255,000.00
		$280,000.00

Solution.

E COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,080,000.00
	$1,080,000.00

Liabilities and Capital

Creditors	$85,000.00
Capital Stock—Fully Paid	855,000.00
Surplus	140,000.00
	$1,080,000.00

Purchase at Less than Book Value

Had E Company, Ltd., in the last example, purchased the shares of F Company for $240,000.00, which is $15,000.00 less than the book value, as may be fair under the circumstances, the $15,000.00 does not constitute a surplus. There has been no realization by Company E of the amount. It is a reduction from the book value of the assets, and should be considered as a reserve against their book value or their values should be adjusted by the amount.

The consolidated Balance Sheet, under the first plan, is—

E COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,080,000.00	
Less Reserve	15,000.00	$1,065,000.00
		$1,065,000.00

Liabilities and Capital

Creditors	$85,000.00
Capital Stock—Fully Paid	840,000.00
Surplus	140,000.00
	$1,065,000.00

Had Company E purchased the shares of two companies, F on terms as above and G with a Paid-up Capital of $300,000.00 and Surplus $35,000.00, for which its own shares $375,000.00 are issued, it is evident that the amount given for G is $40,000.00 above book palue, and for F $15,000.00 below book value. In other words, $40,000.00 was paid for the Goodwill value in the purchase of G.

In a Consolidated Balance Sheet, if the value placed on F is due to low earning power and not to deterioration of assets the Goodwill may be set up at $25,000.00, i.e. $40,000.00 – $15,000.00. On the other hand, if $15,000.00 represents an allowance because of deterioration of assets, it should be shown accordingly as a reserve against them and Goodwill shown at $40,000.00.

Again, suppose that in the total of assets of F Company there was $25,000.00 Goodwill, and that E Company paid $240,000.00. The consolidated Goodwill is $25,000.00 – $15,000.00 or $10,000.00. The reduction of $15,000.00, while not affecting the accounts in F's books, is eliminated when preparing a Consolidated Balance Sheet.

Problem. The Balance Sheets of H Company Ltd., and of I Company Ltd., as on January 1, 19—, are as follows. On that date Company H purchased all the shares of Company I for $200,000.00, for which Company H issued its own shares. Prepare a Consolidated Balance Sheet as when this arrangement had been carried out. Also show the Balance Sheet of Company H at that time.

THE H COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$860,000.00
	$860,000.00
Liabilities and Capital	
Creditors	$60,000.00
Capital Stock—Fully Paid	700,000.00
Surplus	100,000.00
	$860,000.00

THE I COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets		
Sundry		$245,000.00
Goodwill		30,000.00
		$275,000.00
Liabilities and Capital		
Creditors		$45,000.00
Capital Stock—Subscribed and Paid	$250,000.00	
Deficit	20,000.00	
Shareholders' Equity		230,000.00
		$275,000.00

Solution.

H COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,105,000.00
	$1,105,000.00

Liabilities and Capital

Creditors	$105,000.00
Capital Stock—Fully Paid	900,000.00
Surplus	100,000.00
	$1,105,000.00

NOTE. Had Company H paid $210,000.00 for the shares the Consolidated Balance Sheet would show—

H COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,105,000.00
Goodwill	10,000.00
	$1,115,000.00

Liabilities and Capital

Creditors	$105,000.00
Capital Stock—Fully Paid	910,000.00
Surplus	100,000.00
	$1,115,000.00

Had H Company, Ltd., paid $180,000.00 the consolidated Balance Sheet would be—

H COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,105,000.00	
Less Reserve	20,000.00	$1,085,000.00
		$1,085,000.00

Liabilities and Capital

Creditors	$105,000.00
Capital Stock—Fully Paid	880,000.00
Surplus	100,000.00
	$1,085,000.00

For alternative method see next page

H COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$1,105,000.00
	$1,105,000.00
Liabilities and Capital	
Creditors	$105,000.000
Special Reserve against Assets	20,000.00
Capital Stock—Fully Paid	880,000.00
Surplus	100,000.00
	$1,105,000.00

The Balance Sheet of Company H in any of these cases will show the investment at its cost. When purchase price was $200,000.00 the Balance Sheet would be—

H COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$860,000.00
Investment—Shares of Company I	200,000.00
	$1,060,000.00
Liabilities and Capital	
Creditors	$60,000.00
Capital Stock—Fully Paid	900,000,00
Surplus	100,000.00
	$1,060,000.00

Problem. Suppose that, in addition to the purchase of Company I for $180,000.00, Company H at the same date purchased the shares of Company J, whose Balance Sheet follows, for $375,000.00, payable through the issue of shares.

Prepare a Consolidated Balance Sheet as after this is done.

J COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$420,000.00
	$420,000.00
Liabilities and Capital	
Creditors	$80,000.00
Capital Stock—Fully Paid	300,000.00
Surplus	40,000.00
	$420,000.00

Solution.

H COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,525,000.00
Goodwill	15,000.00
	$1,540,000.00

Liabilities and Capital

Creditors	$185,000.00
Capital Stock—Fully Paid	1,255,000.00
Surplus	100,000.00
	$1,540,000.00

Goodwill—$30,000.00 in purchase of J Company less $20,000.00 from purchase of I Company after eliminating Goodwill in Company I's books. Purchase price was $50,000.00 less than the equity given in the Balance Sheet.

Had Company H paid $210,000.00 for the shares of Company I the Consolidated Balance Sheet of the three companies would be—

H COMPANY, LTD., AND SUBSIDIARIES

Consolidated Balance Sheet
January 1, 19—

Assets

Sundry	$1,525,000.00
Goodwill	45,000.00
	$1,570,000.00

Liabilities and Capital

Creditors	$185,000.00
Capital Stock—Fully Paid	1,285,000.00
Surplus	100,000.00
	$1,570,000.00

Goodwill—Equity of Company J	$340,000.00	
Paid for Shares	375,000.00	
Excess		$35,000.00
Equity—Company I, excluding Goodwill	200,000.00	
Paid	210,000.00	
Excess of Purchase Price over tangible Equity		10,000.00
Total Goodwill		$45,000.00

Or

Book Equity of I Company	$230,000.00
Paid for Shares	210,000.00
Excess of Book Equity over Purchase Price	$20,000.00

As book equity includes $30,000.00 for Goodwill, the consolidated Goodwill reduces this by $20,000.00, so that $45,000.00 is made up of $35,000.00

+ $30,000.00 – $20,000.00, or is $45,000.00. It is evident that Company H does not consider $30,000.00 a fair valuation for the Goodwill of Company I.

Holding Company Control Through Subsidiary Holding Company

Reference has already been made to the fact that a chief Holding Company may control another company through its control of a subsidiary that in turn holds a controlling interest in the third company. This relation may extend down to any number of companies, and thus produce a more or less involved situation, although the general principles involved are the same as those already illustrated.

Problem. Following are the Balance Sheets of A Company, Ltd., B Company, Ltd., and C Company, Ltd. Company A owns the capital stock of Company B, which in turn owns the shares of Company C.

Prepare a Consolidated Balance Sheet.

A COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$510,000.00
Investment in Company B	430,000.00
	$940,000.00
Liabilities and Capital	
Creditors	$70,000.00
Capital Stock—Fully Paid	870,000.00
	$940,000.00

B COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$215,000.00
Investment—Company C	235,000.00
	$450,000.00
Liabilities and Capital	
Creditors	$20,000.00
Capital Stock—Fully Paid	430,000.00
	$450,000.00

C COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$250,000.00
	$250,000.00
Liabilities and Capital	
Creditors	$15,000.00
Capital Stock—Fully Paid	235,000.00
	$250,000.00

Solution.

A COMPANY, LTD., AND SUBSIDIARIES

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$975,000.00
	$975,000.00
Liabilities and Capital	
Creditors	$105,000.00
Capital Stock	870,000.00
	$975,000.00

It would be assumed in this case, a very simple one, that Company A paid cash for shares of Company B, which in turn paid cash for shares in Company C. The transactions could not have been carried out by a transfer of shares as, had A gained control of B in this way, B would not have funds nor shares available for the purchase of shares in C.

Problem. Assume that, in the foregoing case, Company A held 90 per cent. of the shares in Company B, which in turn owns 60 per cent. of the shares in Company C, and prepare a Consolidated Balance Sheet.

NOTE. Sundry assets of Company A will be $553,000.00, and of Company B $309.000.00, with investments in other companies reduced accordingly.

A COMPANY, LTD., AND SUBSIDIARIES

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$1,112,000.00
	$1,112,000.00
Liabilities and Capital	
Creditors	$105,000.00
Capital Stock—Fully Paid	870,000.00
Minority Interest—B Co.	43,000.00
Minority Interest—C Co.	94,000.00
	$1,112,000.00

It is evident that Company A controls the whole organization, and the same would hold true if Company C in turn controlled Company D, and Company D controlled Company E, and this continued further down the line.

Problem. The Balance Sheets of Companies D, E, and F follow. These are of the date of January 1, 19—, when Company D acquired 80 per cent. of the shares of Company E, and paid for these by the issue of shares $300,000.00, and a cash payment of $100,000.00. After this, but on the same date, Company E acquired 90 per cent. of the shares of Company F, and paid for these by the issue of shares $100,000.00 and a cash payment for the balance of $160,000.00. Prepare a Consolidated Balance Sheet.

D COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$1,600,000.00
	$1,600,000.00
Liabilities and Capital	
Creditors	$100,000.00
Capital Stock—Fully Paid	1,300,000.00
Surplus	200,000.00
	$1,600,000.00

E COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$500,000.00
	$500,000.00
Liabilities and Capital	
Creditors	$50,000.00
Capital Stock—Fully Paid	350,000.00
Surplus	100,000.00
	$500,000.00

F COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$300,000.00
	$300,000.00
Liabilities and Capital	
Creditors	$30,000.00
Capital Stock—Fully Paid	250,000.00
Surplus	20,000.00
	$300,000.00

Solution.

D COMPANY, LTD., AND SUBSIDIARIES

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$2,140,000.00
Goodwill	57,000.00
	$2,197,000.00
Liabilities and Capital	
Creditors	$180,000.00
Capital Stock—Fully Paid	1,700,000.00
Capital Stock—Minority	95,000.00
Surplus	200,000.00
Surplus—Minority Interest	22,000.00
	$2,197,000.00

Goodwill. Company D purchased an 80 per cent. in Company E, 80 per cent. of ($350,000.00 + $100,000.00) = 80 per cent. of $450,000.00 for $400,000.00, thus indicating a Goodwill value of $40,000.00.

Company E purchased a 90 per cent. interest in Company F, 90 per cent. of ($250,000.00 + $20,000.00) or $243,000.00 for $260,000.00 or $17,000.00 in excess of the book value, or a Goodwill valuation of $17,000.00.

$40,000.00 + $17,000.00 = $57,000.00.

Sundry Assets. Cash $100,000.00 was paid out by Company D to the holders of shares in Company E, while Company E paid out $160,000.00 to the holders of shares in Company F, a total reduction in assets of $260,000.00. Assets $2,400,000.00 – $260,000.00 = $2,140,000.00.

Capital Stock. Company D issued $300,000.00 in new shares. These went out to the holders of shares in Company E, who now become shareholders in Company D.

Company E issued $100,000.00 in new shares to holders of shares in Company F, so that these now become shareholders in Company E, while the Capital Stock of Company F remains unchanged. However, 90 per cent. of this is held by Company E. Total issue by the Holding Company interests is thus $1,300,000.00 + $300,000.00 + $100,000.00 = $1,700,000.00. Company D, Capital Stock $1,600,000.00 and Company E's Capital Stock is $450,000.00.

Minority Interest. Twenty per cent. of the original Capital Stock of Company E remains with former holders—outsiders. This is 20 per cent. of $350,000.00, or $70,000.00.

Ten per cent. of Company F's shares remain with the shareholders, i.e. 10 per cent. of $250,000.00, or $25,000.00.

Total par value of Minority Interest in shares is \$70,000.00 + \$25,000.00, or \$95,000.00.

The same proportions apply to the original surplus. Twenty per cent. or \$20,000.00 of Company E's surplus represents a minority interest while the same is true of 10 per cent. of Company F's surplus of \$20,000.00, or \$2,000.00. Total minority interest in surplus is \$20,000.00 + \$2,000.00, or \$22,000.00. The balance of the surplus shown by Companies E and F is represented in the values purchased by Companies D and E.

Individual Balance Sheets. The Balance Sheets of the individual companies are now as shown below—

D COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	\$1,500,000.00
Investment in Company E	400,000.00
	\$1,900,000.00
Liabilities and Capital	
Creditors	\$100,000.00
Capital Stock	1,600,000.00
Surplus	200,000.00
	\$1,900,000.00

E COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	\$340,000.00
Investment in Company F	260,000.00
	\$600,000.00
Liabilities and Capital	
Creditors	\$50,000.00
Capital Stock	450,000.00
Surplus	100,000.00
	\$600,000.00

F COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	\$300,000.00
	\$300,000.00
Liabilities and Capital	
Creditors	\$30,000.00
Capital Stock	250,000.00
Surplus	20,000.00
	\$300,000.00

Minority Interest in Other Companies

One company may own a part of the shares of another which represents less than a controlling interest. In the previous example, if Company D held 20 per cent. interest in Company G and applied $100,000.00 of its assets in making the purchase, this item would appear as an investment in Company G in the Balance Sheet of Company D, and also in the Consolidated Balance Sheet. It may appear only as "Investment in other companies" and the identity of the company not be revealed.

Taking up Profits of Subsidiaries

Reference has already been made to adjustment of the book value of the investment in subsidiary companies, as recorded in the Holding Company's books, when losses are sustained by the subsidiary companies. This adjustment but follows the accepted practice that all losses should be taken into account when revealed, or appear probable, as a conservative step. The Holding Company appropriates an amount out of net profits equal to the loss, and in this way prevents the carrying of the investment at an amount greater than its real value. The effect is similar to that obtained when a reserve is set up against any investment, the value of which has declined.

It is not usual to write up investment values when they have increased. In the case of a Holding Company, two definite methods are found in practice relative to carrying the values of investments in subsidiary companies in the books.

One of these is to leave the investment at cost, or write it down if the subsidiary sustains losses, the reduction being for the amount by which net assets behind the investment are reduced through the losses sustained. This, as pointed out, is in line with general practice as it affects investments.

The other method is for the Holding Company to take up in its books, not only the amount of losses sustained by the subsidiary but the profits as well. This is based on the theory that the relation between the Holding Company and the subsidiaries is so very close that the profits of the subsidiaries are virtually the profits of the Holding Company.

A Holding Company and its subsidiaries are recognized as constituting one organization, hence the preparation of consolidated statements in addition to those of the individual companies. The fact remains, however, that the Holding Company is in the relation of a shareholder in the subsidiary companies, that profits belong to the corporation earning them, and not to the shareholders directly, since the corporation is an entity apart from its shareholders, and shareholders cannot claim any profits except those declared in dividends to be distributed among them.

The object in bringing the profits of subsidiary companies into the books of the Holding Company is to carry the investment in the subsidiaries at their value as represented by the net value of assets behind them, as shown in the books of the subsidiary companies themselves, adjusted by any Goodwill value allowed for in the purchase price.

If the profits are taken up in this way by the Holding Company, and treated as income or surplus, it follows that when a dividend is declared by a subsidiary it cannot also be income. The treatment of the dividend in this case is similar to that of a dividend declared and paid by a subsidiary out of surplus existing at the time the Holding Company acquired the shares of the subsidiary, i.e. it will be credited to the investment, to write it down. The dividend, when received, represents a payment to the Holding Company of a part of the assets representing the value of the investment.

At this point it may be pointed out that if profits of subsidiaries are not taken up by the Holding Company, and one or more subsidiaries declare and pay dividends the losses, if any, of other subsidiary companies must be taken into account as well as dividends from those showing profits.

Problem. Following are the Balance Sheets of Companies A, B, and C as at December 31, 19—, after recording the net profit or loss for the year. Company A owns all the shares of Companies B and C, through purchase one year earlier.

(*a*) Company A desires the profit of Company B and the loss of Company C to be taken up in its accounts. Make the necessary entries and prepare the Balance Sheet of Company A after giving effect to the entries.

(*b*) After effect is given to the entries in (*a*) Company B declared a dividend of 7 per cent. Record this in the books of Company A.

(*c*) Prepare a Consolidated Balance Sheet after giving effect to the entries.

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$750,000.00
Investment in Company B	300,000.00
Investment in Company C	250,000.00
	$1,300,000.00
Liabilities and Capital	
Creditors	$140,000.00
Capital Stock—Fully Paid	1,000,000.00
Surplus	160,000.00
	$1,300,000.00

B COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry		$350,000.00
		$350,000.00

Liabilities and Capital

Creditors		$30,000.00
Capital Stock—Fully Paid		280,000.00
Surplus		40,000.00
		$350,000.00

C COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Sundry		$245,000.00
		$245,000.00

Liabilities and Capital

Creditors		$20,000.00
Capital Stock—Fully Paid	$240,000.00	
Deduct Deficit	15,000.00	225,000.00
		$245,000.00

Solution. (*a*) Entries in books of Company A—

Investment in Company B	$40,000.00	
To Profits from Company B		$40,000.00
To take up in the accounts, Profits earned by Company B.		
Loss in Company C	15,000.00	
To Investment in Company C		15,000.00
To adjust the Investment Account to reduced value because of loss by Company C.		
Profit and Loss Appropriation	15,000.00	
To Loss in Company C		15,000.00
To write off the loss recorded.		
Profit from Company B	40,000.00	
To Undistributed Profits of Subsidiary Companies		40,000.00
To apply portion of Profits from B to cover loss in C and record the Balance separate from our own realized Surplus.		

A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$750,000.00
Investment in Company B	340,000.00
Investment in Company C	235,000.00
	$1,325,000.00
Liabilities and Capital	
Creditors	$140,000.00
Capital Stock	1,000,000.00
Surplus—Ordinary	145,000.00
Profits of Subsidiaries	40,000.00
	$1,325,000.00

Profits of Company B, when brought into the accounts of Company A, would usually be found credited as income for the year, or to the Appropriation Account as Surplus. As Company A has not received anything on account of these profits, and may not, it is suggested that the profits of subsidiaries, if taken up in the accounts of the Holding Company, should be recorded in an account separate from those recording the surplus of the Holding Company itself. Otherwise the condition may arise when the subsidiary is not in a cash position that would warrant payment of dividends while the Holding Company is in a liquid position, and may possibly appropriate for dividends out of subsidiary profits not received.

(*b*) Entries for Company B dividend, in Company A's books, assuming this was paid immediately after being declared—

Cash	$19,600.00	
To Investment in Company B		$19,600.00
Receipt of Dividend of 7% on B Company Shares $280,000.00.		
Undistributed Subsidiary Profits	19,600.00	
To Profit and Loss		19,600.00

(*c*)

A COMPANY, LTD., AND SUBSIDIARIES B AND C

Consolidated Balance Sheet
December 31, 19—

Assets	
Sundry	$1,345,000.00
Goodwill	30,000.00
	$1,375,000.00
Liabilities and Capital	
Creditors	$190,000.00
Capital Stock—Fully Paid	1,000,000.00
Surplus	185,000.00
	$1,375,000.00

Company A paid $20,000.00 in excess of par for shares of Company B and $10,000.00 in excess of par for shares of Company C when neither had any surplus or deficit, hence Goodwill $30,000.00 in the consolidated statement.

The consolidated surplus was not affected by the entries made. This is the same whether the Holding Company takes up the profits of the subsidiary or not.

In the Balance Sheet of Company A, the investment in Company B stands recorded at $300,000.00 + $40,000.00 − $19,600.00 = $320,400.00 and in Company C $250,000.00 − $15,000.00 = $235,000.00.

Profits Taken up when Subsidiary Shares Not All Held.

Problem. The Balance Sheets of Company E and Company F follow. Company E owns 80 per cent. of the shares of Company F. These were purchased when Company F had a surplus of $40,000.00. Company E proposes to take up in its own accounts its proportion of the profits earned by Company F. Make the necessary entries in Company E's books and prepare a Consolidated Balance Sheet.

E COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$690,000.00
Investment in Company F	385,000.00
	$1,075,000.00
Liabilities and Capital	
Creditors	$35,000.00
Capital Stock—Fully Paid	800,000.00
Surplus	240,000.00
	$1,075,000.00

F COMPANY, LTD

Balance Sheet
December 31, 19—

Assets	
Sundry	$485,000.00
	$485,000.00
Liabilities and Capital	
Creditors	$25,000.00
Capital Stock—Fully Paid	400,000.00
Surplus	60,000.00
	$485,000.00

Solution. Since Company E purchased shares in Company F the latter has earned $20,000.00 of which 80 per cent. is $16,000.00.

Entries in books of Company E—

Investment in Company F	$16,000.00	
To Undistributed Profits of Company F		$16,000.00
To take up 80% of Profits earned.		

E COMPANY, LTD., AND SUBSIDIARY

Consolidated Balance Sheet
December 31, 19—

Assets	
Sundry	$1,175,000.00
Goodwill	33,000.00
	$1,208,000.00
Liabilities and Capital	
Creditors	$60,000.00
Capital Stock—Fully Paid	800,000.00
Capital Stock—Minority Interest	80,000.00
Surplus—Consolidated	256,000.00
Surplus—Minority Interest	12,000.00
	$1,208,000.00

In the books of Company F no entry is made relative to the portion of the surplus taken up in the books of Company E.

Consolidated Surplus. E $240,000.00 + 80 per cent of $20,000.00 earned by F, i.e. $16,000.00.

Goodwill: $385,000.00, purchase price for 80 per cent of ($400,000.00 + $40,000.00 = $440,000.00) or $352,000.00. Excess $33,000.00.

Purchase by Holding Company of New Share Issue

In all examples so far discussed the Holding Company has obtained control through the purchase of the shares in the subsidiary from individual shareholders.

It would be possible to purchase shares at the time of their issue and become a Holding Company in that way.

Problem. Following are Balance Sheets of A Company, Ltd., and B Company, Ltd., as at January 1, 19—.

A COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$800,000.00
	$800,000.00
Liabilities and Capital	
Creditors	$25,000.00
Capital Stock—Fully Paid	650,000.00
Surplus	125,000.00
	$800,000.00

B COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$135,000.00
	$135,000.00
Liabilities and Capital	
Creditors	$22,000.00
Capital Stock—Fully Paid	100,000.00
Surplus	13,000.00
	$135,000.00

On the date stated, Company B made a new issue of $140,000.00 which Company A purchased at 125.

Prepare a Consolidated Balance Sheet after giving effect to this issue of shares.

Solution.

A COMPANY, LTD., AND SUBSIDIARY COMPANY B

Consolidated Balance Sheet
January 1, 19—

Assets	
Sundry	$935,000.00
Goodwill	7,000.00
	$942,000.00
Liabilities and Capital	
Creditors	$47,000.00
Capital Stock—Fully Paid	650,000.00
Consolidation—Minority Interest	100,000.00
Surplus—Consolidation	125,000.00
Surplus—Minority Interest	20,000.00
	$942,000.00

The minority interest before the issue was $113,000.00, while it is now $100,000.00 + $\frac{5}{12}$ of ($13,000.00 + $35,000.00 premium or $48,000.00) = $20,000.00, from which it appears Company A paid $7,000.00 for Goodwill interest.

The book value of Company B's shares before the issue was $113.00, while Company A paid $125.00 for the new shares. The premium representing a capital surplus to Company B adds to the equity of the minority shareholders.

The Balance Sheet of Company A has changed only by a reduction in Sundry Assets and the addition of the same amount as Investment in Shares of Company B.

Company B's Balance Sheet will appear as follows—

B COMPANY, LTD.

Balance Sheet

January 1, 19—

Assets	
Sundry	$135,000.00
Cash	175,000.00
	$310,000.00
Liabilities and Capital	
Creditors	$22,000.00
Capital Stock—Fully Paid	240,000.00
Premium on Shares	35,000.00
Earned Surplus	13,000.00
	$310,000.00

Consolidated Working Sheet

Assets	Company A	Company B	Eliminations	Consolidated
Sundry	$625,000.00	$135,000.00		$760,000.00
Cash		175,000.00		175,000.00
Investment—Company B	175,000.00			
Eliminate Book Value—				
Capital Stock			$140,000.00	
Surplus, $\frac{7}{12}$ of $48,000.00			28,000.00	
Goodwill				7,000.00
	$800,000.00	$310,000.00		$942,000.00

Liabilities and Capital	Company A	Company B	Eliminations	Consolidated
Creditors	$25,000.00	$22,000.00		$47,000.00
Capital Stock	650,000.00	140,000.00	$140,000.00	650,000.00
Capital Stock—Minority		100,000.00		100,000.00
Premium on Shares		35,000.00		
Earned Surplus	125,000.00	13,000.00	$\frac{7}{12}$ 28,000.00	125,000.00
Minority Interest in all B Surplus, Capital and Earned			$\frac{5}{12}$	20,000.00
	$800,000.00	$310,000.00		$942,000.00

If, later on, Company B offered shareholders the right to subscribe for a new issue of shares in proportion to their holdings and all availed themselves of the right, and at the same price per share, the Goodwill would not be affected. Should all not avail themselves of the rights, or if the rights of some minority shareholders were acquired by Company A, who exercised the rights, the proportion would be changed and Goodwill affected.

Shares without Par Value

The fact that some or all of the shares of a subsidiary company have no par value does not affect the procedure when preparing a Consolidated Balance Sheet. The percentage of shares held determines the amounts to be eliminated just as when the shares have a par value. This is true even though the no-par shares have been issued at different rates, within the same class.

Problem. Following are the Balance Sheets of X Company, Ltd., and Y Company, Ltd., at December 31, 19—. On January 1 following, Company X acquired 3,000 shares of Company Y, for which it paid $225,000.00 by the issue of its own shares.

Prepare a Consolidated Balance Sheet after giving effect to the purchase.

X COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$750,000.00
	$750,000.00
Liabilities and Capital	
Creditors	$40,000.00
Capital Stock—Fully Paid	650,000.00
Surplus	60,000.00
	$750,000.00

Y COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets	
Sundry	$360,000.00
	$360,000.00
Liabilities and Capital	
Creditors	$20,000.00
Capital Stock—Fully Paid, 5,000 shares without par value	300,000.00
Surplus	40,000.00
	$360,000.00

Consolidated Working Sheet

Assets	Company X	Company Y	Eliminations	Consolidated
Sundry	$750,000.00	$360,000.00		$1,110,000.00
Investment—Shares Y Co.	225,000.00			
Capital Stock—Y Co.— Eliminate 60%			$180,000.00	
Surplus—Eliminate 60%			24,000.00	
Goodwill				21,000.00
	$975,000.00	$360,000.00		$1,131,000.00

Liabilities and Capital	Company X	Company Y	Eliminations	Consolidated
Creditors	$40,000.00	$20,000.00		$60,000.00
Capital Stock	875,000.00	300,000.00		875,000.00
Eliminate $\frac{3}{5}$ or 60% Y			$180,000.00	
Minority $\frac{2}{5}$ or 40% Y				120,000.00
Surplus —X Co.	60,000.00			60,000.00
Surplus—Y Co.		40,000.00		
Eliminate 60% Y Co.			24,000.00	
Minority 40%				16,000.00
	$975,000.00	$360,000.00		$1,131,000.00

Goodwill: Equity of Y Company $300,000.00 + $40,000.00 = $340,000.00.

Company X purchased $\frac{3}{5}$, representing $204,000.00, for which it paid $225,000.00.

Therefore, Goodwill value in purchase is $21,000.00.

Preferred and Common Shares

In the foregoing examples one class only of shares has been assumed. Greater difficulty may arise if the holdings in a subsidiary company are divided between Preferred and Common shares.

Should the Holding Company own the same proportion of both preferred and common shares no question arises, as the division between the Holding Company and the minority shareholders' interest is just as definite as if only one class of shares have been issued.

Much will depend on the provisions governing the issue of the preferred shares. If the preferred are preferred as to dividends only, they would, in winding up, share any surplus remaining after both classes of shares have been repaid *pro rata* with the common, and that condition has to be considered when preparing a Consolidated Balance Sheet where such is the case. The goodwill valuation can be determined only after the relative equities behind the different classes of shares have been estimated.

The same conditions arise if the preferred shares are preferred as to assets as well as to dividends, with no further restriction, as in that case they share in any surplus remaining after common has been repaid.

On the other hand, if the preferred are preferred as to assets (as well as to dividends) but the preference as to assets is for a definite amount, restricted to that amount and cumulative dividends are fully covered, the whole surplus represents an equity behind common shares alone and division need not be considered.

If the preferred are cumulative and preferred as to dividends and as to assets, but dividends are in arrears, this gives rise to a further question. There is no legal obligation for dividends until declared, but if they have been earned though not declared, they may later be declared out of the existing surplus and, when calculating the equity of the minority interest, their rights against existing surplus for the dividend should be taken into account when determining the relationship of all parties.

Another condition has to be taken into account if the preferred are participating and, again, the position is that while there is no legal claim for dividends not declared, the rights to the surplus should be determined on the basis of the provisions governing the rights of the Holding Company and of the minority interests in the event of dividends being later declared out of the surplus.

Problem. The Balance Sheets of A Company, Ltd., and B Company, Ltd., respectively, are given as on January 1, 19—. On that date Company A purchased a controlling interest in Company B. During the year following, Company B earned net profits of $36,000.00, and Company A earned $60,000.00.

Prepare a Consolidated Balance Sheet as at the close of the year, under each of the following conditions—

(*a*) Company A purchased 80 per cent. of both preferred and common shares of Company B at 105 and 110 respectively. B's preferred dividends were declared and paid in cash at December 31.

(*b*) Company A purchased 60 per cent. of the preferred shares and 90 per cent. of the common shares of Company B at 105 and 110 respectively, and the preferred dividends were declared and paid at December 31.

(*c*) Company A purchased shares as stated in (*b*) and preferred dividends were cumulative but not declared.

(*d*) Preferred shares were participating and entitled to participate with common in any distribution made in any one year after common received the rate attached to the preferred. No dividends have been declared. The amount held by the Holding Company is as stated in (*b*).

Note. In each of the above, assume that the preferred shares are preferred as to assets, restricted in amount to the par value, and to arrears of dividends when the preference for dividends is cumulative.

(*e*) The preferred shares of Company B are ordinary and not cumulative, and no dividend has been declared. The amounts held by the Holding Company are as stated in (*b*).

A COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$1,000,000.00
	$1,000,000.00
Liabilities and Capital	
Creditors	$50,000.00
Capital Stock—Fully Paid	800,000.00
Surplus	150,000.00
	$1,000,000.00

B COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$320,000.00
	$320,000.00
Liabilities and Capital	
Creditors	$20,000.00
Capital Stock—Fully Paid Shares $100.00 par—	
7% Preferred	200,000.00
Common	100,000.00
	$320,000.00

Solution.

(*a*) *Consolidated Working Sheet*

Assets	Company A	Company B	Eliminations	Consolidated
Sundry	$744,000.00	$320,000.00		$1,064,000.00
Investment in Co. B—				
Preferred Shares	168,000.00		$168,000.00	
Common Shares	88,000.00		88,000.00	
Goodwill				16,000.00
Cash (Dividend)	11,200.00			11,200.00
Added by Earnings	60,000.00			60,000.00
From Earnings after Dividends		22,000.00		22,000.00
	$1,071,200.00	$342,000.00		$1,173,200.00

NOTE. Earnings of B Company, $36,000.00, were represented by addition to assets of which 7 per cent. on $40,000.00 or $2,800.00 was paid to minority holders and $11,200.00 paid to Company A.

At the time of the purchase of shares by Company A, the equity of B's shareholders was exactly represented by the Paid-up Capital, 80 per cent. of which is $240,000.00. Company A paid $256,000.00, hence Goodwill $16,000.00.

Liabilities, etc.	Company A	Company B		Eliminations	Consolidated
Creditors	$50,000.00	$20,000.00			$70,000.00
Capital Stock	800,000.00				800,000.00
Preferred B		200,000.00	80% B	$160,000.00	40,000.00
Common B		100,000.00	80% B	80,000.00	20,000.00
Surplus	221,200.00	22,000.00	20% B	4,400.00	238,800.00
Minority Interest 20% B					4,400.00
	$1,071,200.00	$342,000.00			$1,173,200.00

(*b*) *Consolidated Working Sheet*

Assets	Company A	Company B	Eliminations	Consolidated
Sundry	$775,000.00	$320,000.00		$1,095,000.00
Investment Company B				
Preferred 60%	126,000.00		$126,000.00	
Common 90%	99,000.00		99,000.00	
Goodwill				15,000.00
Cash (Dividend)	8,400.00			8,400.00
Added by Earnings after Dividends	60,000.00	22,000.00		82,000.00
	$1,068,400.00	$342,000.00		$1,200,400.00

Goodwill—$5 a share on 1,200 shares and $10 a share on 900 shares.

Liabilities, etc.	Company A	Company B		Eliminations	Consolidated
Creditors	$50,000.00	$20,000.00			$70,000.00
Capital Stock	800,000.00				800,000 00
Preferred B		200,000.00	60%	$120,000.00	80,000.00
Common B		100,000.00	90%	90,000.00	10,000.00
Surplus	218,400.00	22,000.00	Minority	6,600.00	238,200.00
Minority, 10%					2,200.00
	$1,068,400.00	$342,000.00			$1,200,400.00

The surplus, $238,200.00, is made up of $150,000.00 in Company A + Company earnings $60,000.00 + $8,400.00 received by Company A from Company B in dividends, and which remains within the consolidation + 90 per cent. of $22,000.00 or $19,800.00. As the preferred shares have no immediate claim against the surplus, this has been apportioned on the basis of common holdings only.

(*c*) In this example, cumulative preferred dividends have not been declared but they have been earned. While there is no legal obligation at the moment for these arrears, they will, if and when later declared, come out of the earned surplus of B, and this will be taken into account in the Consolidated Balance Sheet.

Consolidated Working Sheet

Assets	Company A	Company B	Eliminations	Consolidated
Sundry	$775,000.00	$320,000.00		$1,095,000.00
Investment Company B,				
Preferred 60%	126,000.00		$126,000.00	
Common 90%	99,000.00		99,000.00	
Goodwill				15,000.00
Added by Earnings	60,000.00	36,000.00		96,000.00
	$1,060,000.00	$356,000.00		$1,206,000.00

Liabilities, etc.	Company A	Company B		Eliminations	Consolidated
Creditors	$50,000.00	$20,000.00			$70,000.00
Capital Stock	800,000.00				800,000.00
Preferred B		200,000.00	60%	$120,000.00	80,000.00
Common B		100,000.00	90%	90,000.00	10,000.00
Surplus	210,000.00	36,000.00	Minority	7,800.00	238,200.00
Minority—Surplus					7,800.00
	$1,060,000.00	$356,000.00			$1,206,000.00

NOTE. The minority portion of surplus is 7 per cent. on $80,000.00 or $5,600.00 + 10 per cent. of $22,000.00 remaining after providing for dividend, or $2,200.00 = $7,800.00.

Sinking Funds of Subsidiaries

Sinking Fund Investments are assets and no question of difficulty arises concerning them. The Sinking Fund Reserve, when the purpose of the sinking fund is to provide for the repayment of a debt, is set up by a book entry showing the appropriation of profits for that purpose. The Sinking Fund Reserve in that case is a part of the earned surplus. It does not constitute a liability to the public.

As already explained, when a Holding Company acquires control of another company, that becomes a subsidiary, the surplus earned by the subsidiary before the Holding Company obtained control does not appear in the Consolidated Balance Sheet, although it is not disturbed in the Balance Sheet of the subsidiary itself. From this it is apparent that the Sinking Fund Reserve of a subsidiary in so far as it was earned and appropriated before the Holding Company obtained control does not enter into the consolidated surplus, while that portion appropriated since the Holding Company obtained control does constitute a part of consolidated surplus.

If the Sinking Fund figures are all shown in the consolidated statement on the above basis, the Investment will appear at an amount much greater than the Consolidated Sinking Fund Reserve, which would give a misleading view of the situation. The question then arises as to how these should be shown. It must be remembered that in the accounts and Balance Sheet of the subsidiary the whole position relative to the sinking fund is disclosed and the question now being considered relates only to the consolidated statement.

A Sinking Fund Reserve is not an absolutely essential feature in connection with sinking funds, so that, as long as the investment is disclosed and indicated as up to requirements or otherwise, it may suffice.

If, then, the consolidated surplus is disclosed, and this includes the portion appropriated to Sinking Fund Reserve since the consolidation, it would meet the situation, especially if a notation is added to state that the subsidiary has a Sinking Fund Reserve on the basis of requirements.

An alternative would be to show the Sinking Fund Reserve in the consolidated statement at its full amount, but this method would require an over-statement of Goodwill or the inclusion of some non-existent asset to produce a balance to the amount of the overstatement of surplus. This, too, may be misleading in its effect.

Problem. Following are the Balance Sheets of C Company, Ltd., and of D Company, Ltd., as at January 1, 19—. At that date Company C acquired 80 per cent. of the shares of Company D, paying therefor $400,000.00. At December 31 of the same year Company C had earned $150,000.00 profits and Company D had earned $40,000.00 profits, of which $5,000.00 had been appropriated to the Sinking Fund Reserve and an equivalent amount had been added to the Sinking Fund Investment. Prepare a Consolidated Balance Sheet as at December 31.

C COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$1,760,000.00
	$1,760,000.00
Liabilities and Capital	
Creditors	$60,000.00
Capital Stock	1,500,000.00
Surplus	200,000.00
	$1,760,000.00

D COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets	
Sundry	$560,000.00
Sinking Fund Investment	40,000.00
	$600,000.00
Liabilities and Capital	
Creditors	$20,000.00
Bonds	100,000.00
Capital Stock	400,000.00
Sinking Fund Reserve	40,000.00
Reserve Fund	30,000.00
Unappropriated Surplus	10,000.00
	$600,000.00

Solution.

C COMPANY, LTD., AND SUBSIDIARY B

Consolidated Working Sheet
December 31, 19—

Assets	Company C	Company D	Eliminations	Consolidated
Sundry	$1,360,000.00	$560,000.00		$1,920,000.00
Sinking Fund Investment		45,000.00		45,000.00
Added to Assets by Earnings	150,000.00	35,000.00		185,000.00
Investment in Co. D	400,000.00		$400,000.00	
Goodwill				16,000.00
	$1,910,000.00	$640,000.00		$2,166,000.00

Liabilities, etc.	Company C	Company D		Eliminations	Consolidated
Creditors	$60,000.00	$20,000.00			$80,000.00
Bonds		100,000.00			100,000.00
Capital Stock	1,500,000.00	400,000.00	80% D	$320,000.00	1,500,000.00
Minority D			20% D		80,000.00
Sinking Fund Reserve		45,000.00	80% D	36,000.00	
			Minority	9,000.00	
Reserve Fund		30,000.00	80% D	24,000.00	
			Minority	6,000.00	
Unappropriated or Sundry Surplus	350,000.00	45,000.00	20% D	9,000.00 M Also $8,000 Jan. 1 (80% of $10,000) and add 80% of $5,000.00 transferred to S.F. Reserve 9000 + 8000 − 4000 = $13,000	382,000.00
Minority—Surplus					24,000.00
	$1,910,000.00	$640,000.00			$2,166,000.00

The Consolidated Surplus is represented by the surplus of Company C at January 1, $200,000.00 + C's profits $150,000.00 + 80 per cent. of D's earnings of $40,000.00 or $32,000.00 = $382,000.00.

Minority Surplus consists of 20 per cent. of Company D's surplus of ($40,000.00 + $30,000.00 + $10,000.00) $80,000.00 or $16,000.00 + 20 per cent. of D's earnings for the year of $40,000.00 or $8,000.00 = $24,000.00.

The amount added to assets by earnings of Company D is $40,000.00, but $5,000.00 of this is already shown in the Sinking Fund Investment.

The shareholders' equity in Company D at January 1 was $400,000.00 + $40,000.00 + $30,000.00 + $10,000.00 or $480,000.00, of which 80 per cent. is $384,000.00. Company C paid $400,000.00, leaving a Goodwill value of $16,000.00.

Stock Dividends

With a Holding Company in control of a subsidiary, and thus directing its policies, it would not be expected that a stock dividend should be declared out of the surplus a subsidiary held when control was obtained by the Holding Company.

A stock dividend declared out of a subsidiary's profits earned after consolidation would, in the books of the Holding Company, involve an entry to add the amount to the investment and credit surplus. If the Holding Company had already taken up in its accounts its share of the profits earned by the subsidiary since control was obtained, no entry would be necessary.

Should a stock dividend be declared partly or wholly out of profits earned by the subsidiary prior to the consolidation, the proportion representing such profits cannot properly be set up as surplus by the Holding Company. Only the portion declared out of earnings since control was obtained should be taken up as surplus and added to the investment.

Problem. Company A purchased 80 per cent. of the shares of Company B. Company B's Capital Stock issued was $196,000.00, and it had at that time a surplus of $40,000.00. The price paid was $200,000.00. During the first year Company B earned a net profit of $30,000.00. A stock dividend was then declared of 25 per cent. or $49,000.00. How should Company A record this and how will the consolidated surplus appear?

Solution. B's total surplus is $70,000.00, of which $49,000.00 has been appropriated for a stock dividend, thus leaving $21,000.00. The amount of $49,000.00 represents the former surplus which does not enter into the consolidation, plus $9,000.00 out of later earned profits. Of $9,000.00 thus applied, 80 per cent. or $7,200.00 goes to the Holding Company, and $1,800.00 to minority interests. The Holding Company, while receiving certificates for shares to the amount of $39,200.00 (80 per cent. of $49,000.00) can add to its investment and surplus only the amount appropriated out of profits earned since consolidation. This is 80 per cent. of $9,000.00 or $7,200.00. The working sheet leading to a Consolidated Balance Sheet then appears as follows—

A COMPANY, LTD., AND SUBSIDIARY B

Consolidated Working Sheet
December 31, 19—

Assets	Company A	Company B	Eliminations	Consolidated
Sundry	$400,000.00	$236,000.00		$636,000.00
Added by Earnings		30,000.00		30,000.00
Goodwill				11,200.00
Investment, Company B	207,200.00		$207,200.00	
	$607,200.00	$266,000.00		$677,200.00

Continued on next page

Liabilities	Company A	Company B		Eliminations	Consolidated
Capital Stock	$600,000.00	$245,000.00	80% B	$196,000.00 (See below)	$600,000.00
Minority, 20% B					49,000.00
Surplus	7,200.00	21,000.00	20% B	4,200.00 Minority	24,000.00
Minority, 20%					4,200.00
	$607,200.00	$266,000.00			$677,200.00

In the above problems it has been assumed that the Holding Company has not taken up in its own accounts the profits earned by the subsidiaries.

Consolidated Operating Statements

Each company within a combination made up of a Holding Company and its subsidiaries is a separate entity, and so prepares its own operating accounts and balance sheet.

The position of the combination as a whole should be arrived at through the preparation of consolidated operating statements prepared in a manner similar to that followed in preparing Consolidated Balance Sheets.

Otherwise it is possible that prosperous companies within the combination will pay dividends to the Holding Company, which in turn are credited to Holding Company Surplus while, in fact, the amounts are offset by losses in other companies. If the Holding Company adjusts its investment in subsidiaries by taking up the losses, there is, however, protection to its surplus. There should be a statement prepared showing, in addition to the profits or losses of individual companies, the profit or loss of the whole combination. In the preparation of such a statement inter-company profits on assets still on hand would be eliminated and a distinction made between the profits of the combination and that representing equity of minority interests.

Vertical and Horizontal Combinations

Reference has been made to the purposes leading to combinations represented by a Holding Company and its subsidiaries.

Vertical. In some cases it is found that the finished product of one company forms the raw material or becomes the stock in trade of another. The operations, from first production to the placing of the product in the hands of the consumer are controlled through one combination. In other words, the product comes up through the operations of the combination. This is termed a vertical combination.

Through its subsidiary the Imperial Oil Company, Ltd., and the subsidiary of this company, the International Petroleum Company, the Standard

Oil Company controls oil operations from the drilling of oil wells through to pouring the oil into a motor engine. This forms a very good example of a vertical combination.

Horizontal. On the other hand, the idea may be rather that of control of a broad market through companies in similar lines operating side by side. An example of this horizontal type of combination is the Dairy Corporation of Canada, which controls subsidiary dairy companies well across Canada. One does not depend on the product of the others, but they operate side by side on similar lines, hence the term Horizontal Combination.

Combination of Two Types. Some combinations include both vertical and horizontal features. For example, the General Motors Corporation, in so far as it manufactures parts through some companies or produces the material for parts through some companies and works up to the finished product through others, illustrates the vertical type. On the other hand, in its endeavours to market cars of practically all price levels, and thus appeal to a very broad market, these cars being the product of different subsidiary companies, it supplies an example of the horizontal type of combination.

The use of the terms "Vertical Combination" and "Horizontal Combination" is rather significant, and should be helpful to any one who has made himself familiar with their meaning.

CHAPTER SEVENTEEN

RECONSTRUCTIONS—REORGANIZATION

Conditions Leading to Reconstructions. When a company's liabilities reach a point that is out of conformity with its assets and earnings, the condition is evidence that the financial plan is not in line with requirements. Assuming that conditions underlying the business are sound, a readjustment of the company's finances, and a re-arrangement of its obligations to bring them into harmony with assets and earning power, should enable the company to operate under more favourable conditions and to obtain better results.

The process of readjustment of a company's finances is usually referred to in Canada and the United States as a reorganization and in Great Britain as a reconstruction. When it is considered that in the process the old structure is taken down and the materials used in the building of a new one, the use of the term "reconstruction" would appear to be very appropriate.

Objects. Reorganizations or reconstructions may be required for any one of several reasons. Some of the possible objects are—

(*a*) To get away from the difficulties due to undercapitalization by raising more capital.

(*b*) To change the capital structure in a manner that will reduce fixed charges and so ease the strain on earnings in a difficult period.

(*c*) To so readjust the financial structure that there will be greater freedom in issuing securities if further capital should be required.

(*d*) To eliminate the strain caused by pressing obligations through refunding or conversion of current obligations into fixed or into capital stock.

(*e*) To cover, without actual cash outlay, arrears of cumulative dividends.

(*f*) To effect a redivision of the shares into different classes.

(*g*) To make a change in the rights attached to shares.

Minor Reorganizations. Reference has already been made to adjustments or changes in the financial structure by reduction of capital stock, increase of capital, and sale of treasury (donated) shares to provide working

capital. These are minor adjustments that do not involve a complete reorganization or reconstruction. Such steps can be effected within the company itself and with a minimum of disturbance.

Usual Method in Reconstructions. The usual method followed when conditions make a complete reorganization or reconstruction necessary is for the company requiring the reorganization to transfer its whole undertaking to a new company formed for the purpose. The consideration will be shares, and possibly other securities, of the new company which are given to the liquidator of the old company to be distributed among the shareholders of the old company or to others, such as creditors who, under the terms of the plan of reconstruction, are entitled to them. When the reconstruction is completed the vendor company surrenders its charter and goes out of existence.

Shareholders of the old company thus become shareholders of the new company, and unless the terms of the reorganization contain other features, such as cash payments for the discharge of creditors, the situation, on its face, appears little changed. It must be borne in mind, however, that in planning the reconstruction the financial plan will be different and is devised to meet the needs of the situation, and that this change can be more easily effected through a new company.

An example of a proposed reorganization involving a Holding Company and its Subsidiaries follows. The terms, if carefully studied, will serve to provide a comprehensive illustration. The details of the financial structure of each of the companies involved are not given and are not necessary for the purpose intended.

It will be sufficient to point out that through some of the constituent companies finding themselves unable to meet their fixed charges, due to a depression that seriously affected the industry, a committee was appointed to draft a plan of reorganization. The proposed plan that is given on pages 273–275 constitutes a part of the report of the committee.

Example.

SECURITIES PROTECTIVE COMMITTEE

OF CANADA POWER AND PAPER CORPORATION

1619 THE ROYAL BANK BUILDING
MONTREAL, QUE.

June 2nd, 1931

To the Holders of Securities and Shares of—

CANADA POWER & PAPER CORPORATION
THE ANTICOSTI CORPORATION
BELGO CANADIAN PAPER COMPANY, LIMITED
LAURENTIDE COMPANY, LIMITED
PORT ALFRED PULP & PAPER CORPORATION
ST. MAURICE VALLEY CORPORATION
WAYAGAMACK PULP & PAPER COMPANY, LIMITED

Present Position

The members of the Securities Protective Committee of Canada Power & Paper Corporation and the above-named constituent companies and representing investors who hold, in the aggregate, large amounts of all classes of securities and shares of these companies, have completed an intensive examination of the Corporation's affairs in the light of conditions now prevailing in the newsprint industry.

This examination has convinced the Committee that, under existing conditions and having regard to volume of newsprint consumption and selling prices, it will be impossible, for some time, to pay any interest or dividends to holders of any of the securities or shares of the above-named companies.

The whole system is severely handicapped by lack of working capital. The acquisition of capital assets, potentially valuable but at present non-productive, and the recent maturing of obligations assumed in that connection have very seriously depleted the current asset position, and have produced an acute situation which must be promptly and effectively dealt with. Apart from other consequences, it has become extremely difficult to finance ordinary manufacturing operations. The Committee is convinced, therefore, that the financial structure of the entire group must be radically revised. The burden of interest and dividend commitments must be drastically reduced. Fixed charges must be practically eliminated for a period of years and working capital must be built up.

The Committee has studied the respective positions of holders of each individual class of security concerned, and has arrived at the unanimous conclusion that any separation which would involve liquidation of any constituent company would result in serious loss to the holders of that company's securities and would jeopardize the prospects of a sound reorganization.

The Plan

After carefully studying and considering all relevant factors, the Plan of Reorganization has been prepared. This Plan has been designed to meet the present difficult situation and to assure to each class of present security holders an equitable share in future earnings.

The Plan, briefly, is to form a New Company, with a capitalization of First Mortgage Bonds (including First Mortgage Sterling Debenture Stock), and one class of shares, which will take over the undertakings and assets of the above-named companies. The new Bonds and Debenture Stock will be on an income basis for five years. These new securities will be made available for exchange for the existing securities on the basis set out in the Plan. No new money is being asked for.

Reduction in Capital

The authorized capitalization of the New Company will consist of $100,000,000 First Mortgage Bonds, including First Mortgage Sterling Debenture Stock, and of 2,000,000 shares without par value. Of the Bonds, $65,000,000 will be authorized for immediate issue as 30-Year 5½% Bonds and Sterling Debenture Stock, which will be on an income basis for five years, but will bear fixed interest thereafter.

The issued capitalization of the New Company on the carrying out of the Plan will compare as follows with the existing capitalization—

Present Capitalization, May 1, 1931 (Excluding Anglo)			Estimated Capitalization New Company (Excluding Anglo)		
*Bonds		$44,365,566.00	*Bonds		$51,058,522.00
Debentures		35,466,700.00	**Wayagamack News Co.	$1,431,774.00	
Preferred		24,000,000.00	***Ha, Ha, Bay Co.	137,300.00	1,569,074.00
Total		$103,832,266.00	Total		$52,627,596.00

Common—1,521,750 no par value Shares.

Capital Stock—1,547,141 no par value Shares.

**In addition to the above Bonds, a further* $8,000,000 (*approximately*) *of new Bonds will be issued in exchange for a like amount of Laurentide First Mortgage Bonds now pledged as collateral to Bank loans.*
***Guaranteed British Treasury, Bonds not exchanged.*
****Bonds not exchanged.*

The Committee will have power to sanction the issue of additional First Mortgage Bonds of the 30-Year 5½% issue, provided that the total is not to exceed $65,000,000, and of such additional Shares as may be considered necessary.

The Committee has deemed it unwise to have the New Company assume the obligations of Canada Power & Paper under the contract for the acquisition of a controlling interest in Anglo-Canadian Pulp & Paper Mills, Limited, and therefore that company is not included in the present Plan.

Distribution to Present Security Holders

The Plan provides that holders of existing First Mortgage Securities will receive First Mortgage Securities of the New Company, and as compensation for loss of accrued interest and foregoing fixed interest for the first five years, will receive Shares of the Capital Stock of the New Company. Holders of Laurentide and Wayagamack Series of Canada Power & Paper Debentures will receive a percentage of new First Mortgage Bonds, together with Shares of the Capital Stock of the New Company. Holders of existing preferred and common Shares will receive Shares of the Capital Stock of the New Company.

To summarize the position of each class of security holders under the Plan:

BELGO BONDHOLDERS receive $125 of New First Mortgage Bonds and One Share of New Stock for each $100 of present Bonds.

BELGO PREFERRED SHAREHOLDERS receive Three Shares of New Stock for each present Preferred Share.

WAYAGAMACK PULP & PAPER FIRST MORTGAGE BONDHOLDERS receive $125 of new First Mortgage Bonds and One Share of New Stock for each $100 of present Bonds.

PORT ALFRED BONDHOLDERS receive $100 of New First Mortgage Bonds and One Share of New Stock for each $100 of present Bonds.

PORT ALFRED FIRST MORTGAGE REGISTERED DEBENTURE STOCKHOLDERS receive £20 of New First Mortgage Sterling Debenture Stock and One Share of New Stock for each £20 of present First Mortgage Registered Debenture Stock.

PORT ALFRED PREFERRED SHAREHOLDERS receive One and One-half Shares of New Stock for each present Preferred Share.

ST. MAURICE BONDHOLDERS receive $100 of New First Mortgage Bonds and One Share of New Stock for each $100 of present Bonds—Series "A" or "B."

ST. MAURICE FIRST MORTGAGE REGISTERED DEBENTURE STOCKHOLDERS receive £20 of New First Mortgage Sterling Debenture Stock and One Share of New Stock for each £20 of present First Mortgage Registered Debenture Stock.

ST. MAURICE PREFERRED SHAREHOLDERS receive One and One-half Shares of New Stock for each $100, or for each 20 Shares of $5 (£1) each, of present Preferred Stock.

ANTICOSTI BONDHOLDERS receive $100 of New First Mortgage Bonds and One Share of New Stock for each $100 of present Bonds.

ANTICOSTI PREFERRED SHAREHOLDERS receive One and One-half Shares of New Stock for each present Preferred Share.

CANADA POWER & PAPER DEBENTURE HOLDERS receive $15 of New First Mortgage Bonds and One and One-half Shares of New Stock for each $100 of present Debentures—Laurentide or Wayagamack Series.

CANADA POWER & PAPER SHAREHOLDERS receive One Share of New Stock for each Ten present Shares.

Provision has been made in the Plan so that the odd Common Shares of Belgo, Port Alfred, St. Maurice, and Wayagamack, outstanding in the hands of the public, may be exchanged for new Shares.

This scale of distribution is based not only upon a careful analysis of the assets and earning power represented by each

existing security, but upon such other important factors as inter-company obligations (including leases), the effect of separation upon operating costs, existing newsprint contracts, and the advantage of maintaining a well-established selling organization.

Management

The Committee recognizes that holders of securities who forego fixed charges for five years will expect assurance as to management, especially during the period in which their right to receive interest depends on earnings and current assets. The Plan provides, therefore, that the Committee will nominate a majority of the new Board of Directors to serve for five years.

Co-operation of Important Interests

The Plan has been submitted to the Bankers of the Corporation (the Bank of Montreal and The Royal Bank of Canada), who have expressed their willingness, if the reorganization Plan is carried out, to make banking arrangements with the New Company which the Committee considers will be satisfactory.

Holders of large amounts of all classes of the securities have assured the Committee that they will support the Plan.

Prospects

While it is not possible to forecast accurately the operating results of the New Company, the Committee believes that the Plan provides the foundation for success, first by creating a capital structure which will not involve burdensome fixed charges in the earlier years during which conditions will be most difficult, and secondly by permitting the accumulation of working capital.

The unknown factors in the situation include the percentage of mill capacities for which markets may be found and the prices which will prevail; but, given prices on any fair basis and assuming the fulfilment of existing newsprint contracts, the Committee feels warranted in expecting results which will be advantageous to those participating in the Plan.

The Committee believes that no group of properties in the newsprint industry will be better balanced for economic production or will possess more favorable prospects than the New Company, providing a reorganization is arranged along the lines indicated.

General

A Deposit Agreement has been executed by the Committee and lodged with each of the Depositaries (the Bank of Montreal and The Royal Bank of Canada). A copy of this Agreement is annexed to and is part of the Plan. Security holders become parties to the Agreement and entitled to participate in the Plan by depositing their securities with one of the Depositaries. The Bank will issue to each depositor an appropriate Deposit Certificate. The Committee is acting without compensation, and there will be no expense to depositors except for postage and insurance. Expenses in connection with the Plan are ultimately to be assumed by the New Company.

The Committee strongly urges all security holders to study the Plan and Agreement, and to promptly forward their securities, endorsed as required, to the nearest Depositary. The members of the Committee have no hesitation in expressing their conviction that the support of the Plan by the prompt deposit of securities is in the best interests of all the security holders.

On behalf of the Committee:

CHAS. A. DUNNING, *Chairman*.

COMMITTEE

HON. CHAS. A. DUNNING, P.C., *Chairman*

R. H. COLLIS
of Kitcat & Aitken, London, England

NORMAN J. DAWES
President, Montreal Board of Trade

H. D. LOCKHART GORDON, C.A.
Clarkson, Gordon, Dilworth, Guilfoyle & Nash, Toronto

STRACHAN JOHNSTON, K.C.
Tilley, Johnston, Thomson & Parmenter, Toronto

STEWART KILPATRICK
Govett, Sons & Co., London, England

E. A. MACNUTT
Treasurer, Sun Life Assurance Company of Canada

JOHN J. RUDOLF
A. Iselin & Co., New York

GORDON W. SCOTT, C.A.
P. S. Ross & Sons, Montreal, Secretary
1619 The Royal Bank Building, Montreal

DEPOSITARIES

BANK OF MONTREAL
THE ROYAL BANK OF CANADA

COUNSEL

J. L. RALSTON, K.C.
Mitchell, Ralston, Kearney & Duquet, Montreal

Position of Creditors. When one or more companies sell their assets and undertakings to a new company, without provision for the immediate discharge of liabilities, the agreement will provide that the purchasing company shall assume all contracts, engagements, debts, and liabilities of the vendor companies. At the same time, it is necessary that the purchasing company enter into an agreement to indemnify the vendor companies against the claims of their respective creditors.

As the creditors were of the old companies and the covenant of indemnity is also given to the old company, the old companies would appear to be the parties against whom the creditors have the right of action, while it is the old companies that have recourse under the covenant of indemnity against the new company.

Should creditors not be paid, or be otherwise provided for in a manner satisfactory to them, they may exercise their rights under the Bankruptcy Act, Bulk Sales Act (where such is in force), or other statutes that exist for their protection.

Dissentient Shareholders. Should a shareholder (or a minority group) refuse to vote for the resolution to sell the business to another company, he may either take steps to prevent the liquidator from putting the resolution into effect or require the liquidator to purchase his interest at a price to be fixed by agreement or, failing agreement, at a price to be fixed by arbitration. The exact procedure in such a case will rest largely on the provisions of the Act under which the company is formed, and on the charter and by-laws that govern its action.

A plan frequently followed is to have the shares not taken up by a minority group allotted to someone on behalf of the liquidator, who sells them for the best prices obtainable and divides the proceeds among the shareholders who refuse to become parties to the reconstruction.

Reconstruction where there has been Loss of Capital

Where there has been a loss of capital and the working capital position is unsatisfactory, a reduction of capital itself will not likely be sufficient. New working capital is required and, as a further step toward a revised working capital position, a compromise with creditors may be desirable.

For a company in such a position to obtain further working capital would be a difficult matter. This gives rise to the plan usually followed, of having a new company formed to take over the undertaking of the old under a definite agreement and plan.

There will be a liquidator for the company that is being wound up, and

he is responsible to the creditors and shareholders of that company for the distribution of the consideration received by him.

Problem. The balance sheet of the A Company, Ltd., follows—

A COMPANY, LTD.

Balance Sheet
January 1, 19—

Assets			
Current			
Bank—on Deposit		$3,000,00	
Accounts Receivable	$26,000.00		
Bills Receivable	30,000.00		
	56,000.00		
Less Reserve for Bad Debts	2,000.00	54,000.00	
Inventories—Goods		60,000.00	$117,000.00
Fixed			
Land		30,000.00	
Buildings	$60,000.00		
Less Reserve—Depreciation	4,000.00	56,000.00	
Plant and Machinery	120,000.00		
Less Reserve—Depreciation	18,000.00	102,000.00	188,000.00
Patents			60,000.00
Organization Expense			10,000.00
			$375,000.00
Liabilities			
Sundry Creditors		$45,000.00	
Bank Loan		70,000.00	$115,000.00
Bonds			75,000.00
Shareholders' Equity			
Capital Stock—Paid-up			
7% Preferred		$150,000.00	
Common		55,000.00	
		205,000.00	
Less Deficit		20,000.00	185,000.00
			$375,000.00

The company finds itself financially embarrassed, but it is considered that the possibilities for successful operation are favourable if the working capital position can be satisfactorily adjusted. The bank loan is secured by inventories and receivables.

A scheme of reorganization has been brought forward and approved.

The terms are—

1. That a new company, the B Company, Ltd., is to be formed to take over the business and undertaking of the A Company, Ltd. The B Company, Ltd., is to have an authorized capital stock of $400,000.00 in 7 per cent. preferred and 5,000 common shares without par value.

2. That A Company, Ltd., go into voluntary liquidation.

3. That the assets of A Company, Ltd., be taken over at book value, except that Organization Expense is to be eliminated and the value of the patents will bear any further adjustments made.

4. The creditors are to be settled with as follows—

(*a*) Bank Loan paid in full and security released.

(*b*) Wages $2,000.00 are to be paid by cash in full. Other creditors (unsecured) to accept a reduction in claims of 10 per cent., receive 40 per cent. of face amount of claims in cash and accept fully-paid preferred shares at par with a bonus of one share common with each share preferred, for the balance.

(*c*) Bondholders are to receive bonds of the new company in exchange for those now held, and for a like amount.

(*d*) Holders of common shares are to be given 5,000 shares of common in exchange for shares now held, the new shares to be set up at $8.00 a share, all credited to capital.

(*e*) Holders of preferred shares are to exchange their present holdings for a like amount in preferred shares of the new company, 60 per cent. paid up. The balance is payable by these holders in cash. A bonus of one share of common will be given with each share of preferred so issued.

(*f*) A further issue of preferred shares, $50,000.00 is to be made at par and a bonus of one share of common is to be given with each share of preferred issued.

(*g*) The bonus shares are to be provided by the holders of common to whom they are issued in consideration of the surrender of this equity.

(*h*) Liquidation expenses of $1,000.00 are to be paid by Company B as part of the purchase consideration.

Make entries in the books of both companies to record the carrying into effect of the reorganization plan submitted, to which all parties concerned have given their approval.

Prepare the balance sheet of the new company as after the terms of the reorganization plan are put into effect.

Solution. Entries in the books of A Company, Ltd.—

Reserve for Depreciation—Buildings	$4,000.00	
To Buildings		$4,000.00
Reserve for Depreciation—Plant and Machinery	18,000.00	
To Plant and Machinery		18,000.00

Realization	$377,000.00	
To Bank		$3,000.00
,, Accounts Receivable		26,000.00
,, Bills Receivable		30,000.00
,, Inventories		60,000.00
,, Land		30,000.00
,, Buildings		56,000.00
,, Plant and Machinery		102,000.00
,, Patents		60,000.00
,, Organization Expense		10,000.00
Transferring Asset Accounts to Realization Account.		
Reserve for Bad Debts	2,000.00	
To Realization		2,000.00
Creditors	4,300.00	
To Realization		4,300.00
Allowance from Claims.		
B Company, Ltd.	316,700.00	
To Realization		316,700.00
Amount of Consideration.		
Cash (for Wages)	2,000.00	
,, (for Creditors)	17,200.00	
,, (for Bank)	70,000.00	
Bonds—B Company	75,000.00	
Preferred Shares—B Company $150,000.00—60% paid.	90,000.00	
Common Shares—B Company 5,000 Shares without Par Value.	40,000.00	
Cash—Liquidation Expenses	1,000.00	
Preferred Shares—B Company (for Creditors)	21,500.00	
To B Company, Ltd.		316,700.00
Realization	1,000.00	
To Cash—Liquidation Expense		1,000.00
Creditors—Wages	2,000.00	
,, —Ordinary	17,200.00	
Bank Loan	70,000.00	
To Cash		89,200.00
Payments to Creditors as provided.		
Creditors	21,500.00	
To Preferred Shares—B Company		21,500.00
Settlement with Ordinary Creditors.		
Bonds	75,000.00	
To Bonds—B Company		75,000.00
Exchange of Bonds.		
Capital Stock—Preferred	150,000.00	
Capital Stock—Common	55,000.00	
To Shareholders		205,000.00
Closing out Capital Stock Accounts.		
Shareholders	75,000.00	
To Deficit—(P. and L. Appropriation)		20,000.00
,, Realization		55,000.00
To charge Shareholders with Deficit and with Loss in Realization.		
Shareholders	130,000.00	
To Preferred Shares—B Company		90,000.00
,, Common Shares—B Company		40,000.00

The Ledger Accounts for Realization and Shareholders follow—

Dr. *Realization* *Cr.*

Date				Date			
19—				19—			
Jan. 1	Sundry Assets	J.	$377,000.00	Jan. 1	Reserve for Bad Debts	J.	$2,000.00
	Cash—Liquidation	J.	1,000.00		Creditors	J.	4,300.00
					B. Company, Ltd.	J.	316,700.00
					Shareholders	J.	55,000.00
			$378,000.00				$378,000.00

Dr. *Shareholders* *Cr.*

Date				Date			
19—				19—			
Jan. 1	Profit and Loss Deficit	J.	$20,000.00	Jan. 1	Capital Stock—Preferred	J.	$150,000.00
	Realization	J.	55,000.00		Capital Stock—Common	J.	55,000.00
	Preferred Shares—B Company	J.	90,000.00				
	Common Shares—B Company	J.	40,000.00				
			$205,000.00				$205,000.00

Dr. *B Company, Ltd.* *Cr.*

Date				Date			
19—				19—			
Jan. 1	Realization	J.	$316,700.00	Jan. 1	Sundries	J.	$316,700.00

Only one account has been opened for shareholders. Two could have been used. The loss in realization, $55,000.00, could be closed to the account recording the deficit, which would then have a debit balance of $75,000.00.

The account for Preferred shareholders, having been credited with $150,000.00 and charged with $90,000.00, would then be closed by charging it with $60,000.00 transferred from the deficit.

The account for Common shareholders, having been credited with $55,000.00 and charged with $40,000.00, would be closed by transferring to it, as a charge, $15.000,00 of the deficit.

All accounts are then closed.

Entries in the books of B Company, Ltd.—

Bank	$3,000.00	
Accounts Receivable	26,000.00	
Bills Receivable	30,000.00	
Inventories	60,000.00	
Land	30,000.00	
Buildings	56,000.00	
Plant and Machinery	102,000.00	
Patents	11,700.00	
To A Company, Ltd.		$316,700.00
,, Reserve for Bad Debts		2,000.00

Assets acquired.
Patents are taken over at adjusted value.
Assets in Company A's books, $377,000.00
– Reserve, $2,000.00 – Organization Expenses
$10,000.00 = $365,000.00
Consideration 316,700.00
Adjustment 48,300.00
Patents $60,000.00 – $48,300.00 = $11,700.00

Subscribers—Preferred	221,500.00	
To Capital Stock—Preferred		221,500.00
Issue of Preferred Shares.		
Subscribers—Common	40,000.00	
To Capital Stock—Common		40,000.00
Issue of 5,000 Common Shares N.P.V. at $8.00.		
Cash	110,000.00	
To Subscribers—Preferred		110,000.00
Payments received.		
A Company, Ltd.	316,700.00	
To Cash		90,200.00
,, Bonds		75,000.00
,, Subscribers—Preferred		111,500.00
,, Subscribers—Common		40,000.00

The balance sheet of B Company, Ltd., which follows, discloses the improved position of the undertaking after the reconstruction has been completed.

B COMPANY, LTD.

Balance Sheet

——— —, 19—

Assets

Current			
Cash and Bank		$22,800.00	
Accounts Receivable	$26,000.00		
Bills Receivable	30,000.00		
	56,000.00		
Less Reserve for Bad Debts	2,000.00	54,000.00	
Inventories—Goods		60,000.00	$136,800.00
Fixed			
Land		30,000.00	
Buildings		56,000.00	
Plant and Machinery		102,000.00	188,000.00
Patents			11,700.00
			$336,500.00

Liabilities and Capital

Current		
None		
Fixed		
Bonds		$75,000.00
Shareholders' Equity		
Capital Stock—Fully Paid		
Preferred	$221,500.00	
Common—5,000 Shares without Par Value	40,000.00	261,500.00
		$336,500.00

Whether the additional preferred shares are issued to the present shareholders or to outsiders is immaterial, and the possibility of issuing to outsiders will depend on the evident possibilities of success in future operations.

The agreement of the holders of common shares to transfer a part of the shares they receive, as a bonus to those to whom the preferred is issued, leaves the common shareholders with 2,785 shares only. The common shares of A Company, Ltd., had apparently been issued for rights which are transferred at a reduced valuation and this reduction in holdings, the only sacrifice contributed by the common, may be well worth while. The giving by the common shareholders of their shares in this way induces others to put in cash in return for preferred shares. Without the additional capital funds thus obtained the common would have no equity behind it. There is now a possibility that if the company is successful the common shares may become of greater value.

Instead of the bonus feature being introduced, the holders of preferred shares may have received preferred shares and common shares in the new company on the payment of a certain amount in cash. This would be in

return for the surrender of their rights in the old company. The bonus feature has been brought in as a further illustration to emphasize the source of bonus shares and the fact that they do not affect the records in the financial books.

The liquidator of A Company, Ltd., is responsible to the creditors and shareholders of that company in carrying out the terms of the reorganization, and as he discharges the liabilities the records for this are made in the books of A Company, Ltd. The liabilities were of the A Company, Ltd.

B Company, Ltd., commences operations with a very favourable balance sheet.

Formation of a new company facilitates a reconstruction or reorganization. It would be more difficult for the old company in the financial position presented to reconstruct its financial structure and obtain further capital funds. The formation of a new company that will commence operations with a favourable financial position inspires greater confidence.

CHAPTER EIGHTEEN

PREFERRED SHARES IN WINDING UP

Relation of Shareholders in Winding Up

Preference. The nature and extent of the preference attached to preferred shares cannot be taken for granted or assumed to be of any one particular character. The preference is as stated in the charter or by-laws creating the preferred shares and defining their right. Legal decisions have assisted in interpreting the relations between different classes of shares.

From legal decisions certain well-defined relationships, under conditions referred to, are established. A change in the statutes would possibly change these relationships, since legal decisions interpret the law as it is. The terms of the charter or by-laws must be considered to determine the exact terms of shares issued and thus to know whether the decisions apply. Some of the features relative to preferred shares, that are supported by legal decisions, are—

1. In the absence of words in the charter or by-law creating preferred shares, limiting the preference, the preferential dividend is *prima facie* cumulative and means a dividend having preference over the whole income of the company during the whole period of its existence, or during as many years as may be necessary to satisfy the claim of dividend. *Milne* v. *Arizona Copper ; Crockett* v. *Academy of Music.*

2. If the preference shareholders are declared to be entitled to be paid their dividend out of the net profit of each year, the dividend is not cumulative. *Staples* v. *Eastman Photographic Materials.*

3. If it is desired to confer on preferred shareholders the right to participate further in the profits of the company after the payment of the fixed preferential dividend, it must be so distinctly stated; otherwise the right is impliedly negatived. *Will* v. *United Lanket Plantation Co. Re National Telephone Co.*

4. A preference as to dividend does not carry with it a preference as to return of capital or distribution of surplus in winding up. *In re London India Rubber Co.* The general rule, which it requires an express provision to exclude, is that both classes of shareholders rank *pro rata*. *Morrow* v. *Peterborough Water Co.* Where it is desired to confer such a right, proper words must be inserted in the by-law or letters patent creating the issue.

5. If the right to a priority in return of capital exists, the preference shareholders, in the absence of any provision to the contrary, are also entitled to participate rateably with the other shareholders in the distribution of any surplus assets that may be available for such purpose. *In re Espuela Land and Cattle Co.*

6. Where dividend is cumulative, and it is provided that the surplus assets in the event of winding up are to be applied first in repaying the preference capital; and secondly in paying off arrears, if any, of the preferential dividend to the commencement of winding up, the preference shareholders are entitled to payment of arrears of dividend out of surplus assets, even though no dividends have been declared. *In re New Chinese Antimony Co.* The view set out by authorities on this subject is that when there is such a definite provision it will apply whether there are profits or not.

7. In winding up, if some shareholders have paid more than others, the liquidator may make calls for the purpose of adjusting the rights of contributories. *Re Monarch Bank of Canada.*

8. Where the assets are sufficient to permit of equalization without making of calls, the surplus will be paid to the shareholders who have paid more than the others, to the extent of such excess and the balance only will be equally divisible among all the shareholders. *Re Wakefield Rolling Stock Co.*; also *re Colonial Assurance Co.*

9. In the absence of restrictive provisions, preferred shares participate with all the shareholders in proportion to the nominal value of the shares, where the shares are of unequal amount. *Re Espuela Cattle Co.*

10. Where the right of the preference shareholders to participate further was excluded, the common shareholders were entitled to the surplus after repayment of capital to all shareholders, such surplus being divisible in proportion to the amount of their shares and not the amount paid thereon. *Morrow* v. *Peterborough Water Co.*

11. Where payments have been made by shareholders in advance of calls, such shareholders are entitled to the return of such sums with interest before other shareholders of equal rank receive anything. *Re Wakefield Rolling Stock Co.*

The decisions that have been quoted make it very clear that to determine the rights of shareholders, the charter of the company, the company's by-laws, and the Act under which the company is formed should be carefully studied and, with this done, the records of the courts may clear matters still in doubt.

Problem. The balance sheet of the A Company, Ltd., as at December 31, 19—, is given below.

THE A COMPANY, LTD.

Balance Sheet
December 31, 19—

Assets

Cash	$850,000.00
	$850,000.00

Liabilities and Capital

Creditors	$50,000.00	
Shareholders' Equity		
Capital Stock—Fully Paid		
Preferred—7%	400,000.00	
Common	240,000.00	
Surplus	160,000.00	160,000
	$850,000.00	

All assets have been realized and the company is being wound up.

Show how the cash will be distributed if—

(*a*) Preferred shares are preferred as to dividends only.

(*b*) Preferred shares are preferred as to dividends and also to par value of principal in winding up. There is no further restriction stated.

(*c*) Preferred shares are preferred as to dividends and also restricted to repayment at par in winding up.

(*d*) Preferred shares are preferred as to dividends and there is the further provision that, in winding up, the surplus assets after paying creditors are to be applied first to cover arrears (if any) of preferred dividends; and second to paying off the preferred shares at 110, the payment to preferred being limited to these amounts. Preferred dividends are two years in arrears and have not been declared.

Also show the division of assets in each case, if the assets after paying creditors amount to only $560,000.00.

Solution. (*a*) In this instance the preference stated in the charter or by-laws refers only to dividends, and no reference is made to any preference in winding up. Both classes of shares will receive payments *pro rata*. For purpose of illustration all entries are given in Journal form.

Entries—

Creditors	$50,000.00	
To Cash		$50,000.00
Settlement with Creditors.		

Capital Stock—Preferred	$400,000.00	
Surplus	100,000.00	
To Shareholders—Preferred		$500,000.00
To transfer Par Value of Preferred Shares and 40/64 of $160,000, or $100,000.00 Surplus to Credit of Preferred Shareholders.		
Capital Stock—Common	240,000.00	
Surplus	60,000.00	
To Shareholders—Common		300,000.00
To transfer Par Value of Common Shares and 24/64 of $160,000.00 or $60,000.00 of Surplus to Credit of Common Shareholders.		
Shareholders—Preferred	500,000.00	
To Cash		500,000.00
Payment to Preferred Holders.		
Shareholders—Common	300,000.00	
To Cash		300,000.00
Settlement with Holders of Common.		

Had there been no surplus, but assets after paying creditors had amounted to only $560,000.00, the balance sheet would have shown a deficit of $80,000.00. The amount, $560,000.00, would be divided between the holders of the preferred and common shares *pro rata*. There is no preference stated in winding up.

Entries, after payment of creditors—

Capital Stock—Preferred	$400,000.00	
To Shareholders—Preferred		$400,000.00
Shareholders—Preferred	350,000.00	
To Cash		350,000.00
400/640 of $560,000.00 = $350,000.00.		
Capital Stock—Common	240,000.00	
To Shareholders—Common		240,000.00
Shareholders—Common	210,000.00	
To Cash		210,000.00
240/640 of $560,000.00 = $210,000.00.		
Shareholders—Preferred	50,000.00	
Shareholders—Common	30,000.00	
To Deficit		80,000.00
40/64 of $80,000.00 = $50,000.00. 24/64 of $80,000.00 = $30,000.00. To transfer deficit—*pro rata*—to accounts of shareholders and to close out accounts.		

The divisions in this solution are based on the fact that no preference has been provided for in winding up and that the preference can exist only if it is provided for when the preferred shares are created.

(*b*) The preference in this case extends to the division of assets in winding

up, but there is no restriction that fixes a limit that may be received by the preferred. The order in which the assets are appropriated is: (1) Par value of preferred to preferred shareholders; (2) Par value of common to holders of common; (3) Division of surplus *pro rata* between preferred and common.

Entries—

Creditors	$50,000.00	
To Cash		$50,000.00
Capital Stock—Preferred	400,000.00	
To Shareholders—Preferred		400,000.00
Capital Stock—Common	240,000.00	
To Shareholders—Common		240,000.00
Surplus	160,000.00	
To Shareholders—Preferred		100,000.00
,, Shareholders—Common		60,000.00
Shareholders—Preferred	500,000.00	
To Cash		500,000.00
Shareholders—Common	300,000.00	
To Cash		300,000.00

From these entries it is apparent that if, in winding up, a company has a surplus, the division between preferred and common shareholders is the same under the conditions of a preference as to principal, but not limited to that preference, as if there were no preference.

A difference will be apparent when, instead of a surplus, the company has incurred a deficit. With assets of $560,000.00 after paying creditors, the entries in this case are—

Capital Stock—Preferred	$400,000.00	
To Shareholders—Preferred		$400,000.00
Shareholders—Preferred	400,000.00	
To Cash		400,000.00
Capital Stock—Common	240,000.00	
To Shareholders—Common		240,000.00
Shareholders—Common	80,000.00	
To Deficit		80,000.00
To write off Deficit as a Charge to Holders of Common Shares.		
Shareholders—Common	160,000.00	
To Cash		160,000.00
Settlement with Holders of Common Shares.		

The point that stands out in this instance is that when there is a deficit and a preference as to principal, the full weight of the deficit is thrown on to the common.

(*c*) The preferred shares are restricted to receiving par value, but are preferred to that amount.

Entries—

Creditors	$50,000.00	
To Cash		$50,000.00
Capital Stock—Preferred	400,000.00	
To Shareholders—Preferred		400,000.00
Capital Stock—Common	240,000.00	
Surplus	160,000.00	
To Shareholders—Common		400,000.00
Shareholders—Preferred	400,000.00	
To Cash		400,000.00
Shareholders—Common	400,000.00	
To Cash		400,000.00

When there is a surplus and the preferred are restricted to a definite amount, all surplus after providing for the preferred is given to the common.

Had the preferred been entitled to 110 instead of 100, then $40,000.00 of the surplus would have been transferred to the credit of the holders of preferred, who would then be paid $440,000.00.

Had there been only $560,000.00 of assets after paying creditors, the entries would have been—

Capital Stock—Preferred	$400,000.00	
To Shareholders—Preferred		$400,000.00
Capital Stock—Common	240,000.00	
To Shareholders—Common		240,000.00
Shareholders—Common	80,000.00	
To Deficit		80,000.00
To charge Deficit to Common.		
Shareholders—Preferred	400,000.00	
To Cash		400,000.00
Shareholders—Common	160,000.00	
To Cash		160,000.00

Here, again, the effect is, if there is a deficit, to charge the whole amount against the holders of common shares.

Had the preferred been entitled to repayment at 110, the deficit to be charged to common would have been increased by $40,000.00. The preferred would then receive $440,000.00 and the common $120,000.00. It is

not so easy to find a logical entry for this. The most convenient entries would be—

Entries—

Deficit Account	$40,000.00	
To Shareholders—Preferred		$40,000.00
and		
Shareholders—Common	120,000.00	
To Deficit		120,000.00

Should these entries be set up, the inference is not that the preferred shareholders are credited with an actual deficit, but that the deficit against the common shares is increased by $40,000.00. The alternative entry would be to charge the holders of common shares and credit the holders of preferred shares with $40,000.00, the deficit then being charged to common at $80,000.00.

(*d*) The provisions relating to dividends as applied here are quite equitable for there is a surplus and also arrears of dividends. The dividends have not been declared; but, under the provisions in the charter or by-laws, the declaration may be deemed automatic in the event of winding up. This is based on the decision *re New Chinese Antimony Co*. The entries for purpose of illustration are—

Creditors	$50,000.00	
To Cash		$50,000.00
Capital Stock—Preferred	400,000.00	
Surplus—Arrears of Dividends	56,000.00	
Surplus—Premium on Redemption	40,000.00	
To Shareholders—Preferred		496,000.00
To credit holders of Preferred Shares with amounts due them in winding up as provided in charter (or by-laws).		
Capital Stock—Common	240,000.00	
Surplus	64,000.00	
To Shareholders—Common		304,000.00
To credit holders of Common Shares with Par Value of Shares plus Surplus remaining after meeting requirements of Preferred.		
Shareholders—Preferred	496,000.00	
To Cash		496,000.00
Shareholders—Common	304,000.00	
To Cash		304,000.00
Settlement with Shareholders.		

Should the assets amount to only $560,000.00 after the creditors are paid a rather strange situation develops. In legal decisions, including that *re Springbok Agricultural Estates, Ltd.*, it has been held that the provision as to arrears of dividends under the terms used in the problem, apply whether there are profits or not; and, of course, where there is a deficit, the dividends

would not have been declared. The provision relates to the return to be given to the holders of preferred shares in winding up rather than to the distribution of profits. In other words, the provisions relate to a distribution of assets in general, and are not to be construed as relating to the distribution of assets obtained through profit. The entries then are similar to those already given, except that there is a deficit to deal with instead of a surplus. The first provision relates to arrears of dividends, but all credits may be recorded in one entry.

Capital Stock—Preferred	$400,000.00	
Deficit—Arrears of Dividends	56,000.00	
Deficit—Redemption Premium	40,000.00	
To Shareholders—Preferred		496,000.00
To record Credits due in winding up to the Preference Shareholders.		
Capital Stock—Common	240,000.00	
To Shareholders—Common		240,000.00
Shareholders—Common	176,000.00	
To Deficit		176,000.00
$80,000.00 + $56,000.00 + $40,000.00 = $176,000.00.		
Shareholders—Preferred	496,000,00	
To Cash		496,000.00
Shareholders—Common	64,000.00	
To Cash		64,000.00

Had there been insufficient assets to give the preference shareholders all that would have been due to them, the account for the preference shareholders would have been charged with an amount of the deficit equal to the deficiency in the amount available for them. The balance of the deficit account would then equal the capital stock—common, and be applied to write it off.

Different Amounts Paid on Shares. Payment in Advance of Calls. The procedure in winding up where some shareholders have paid more than others on account of their shares seems to be quite clear. If there are assets, after paying creditors, equal to the paid-up capital, no question arises. The shareholders all receive the amount they have paid in. Should there be insufficient to repay all capital contributed, but sufficient to equalize the equity in the shares, payments would be made to cover the excess paid by some over the amount paid by others. After that, the payments to shareholders within a class will be at the same rate on each share.

If the assets are insufficient to equalize the shares, calls may be made by the liquidator on those who have paid the smaller amounts with a view to putting all on the same basis. If this is not done, or at least taken into account, some shareholders may suffer, not because of operating losses only, but because of the failure of other subscribers to pay in their promised contribution.

Should some shareholders have paid in advance of calls, such amounts are repayable before amounts paid on account of calls actually made. While they do not appear to be recognized as creditor loans, they do come in after creditor loans and before paid-up capital. After all creditors have been satisfied, including loans, these advance payments stand first.

Problem. A Company, Ltd., in the course of winding up, has disposed of all its assets except cash from realization. The balance sheet as at May 1, 19—, follows—

A COMPANY, LTD.

Balance Sheet
May 1, 19—

	Assets		
Cash			$700,000.00
Deficit			20,000.00
			$720,000.00
	Liabilities		
Creditors			100,000.00
Shareholders' Equity			
Capital Stock			
Preferred	$500,000.00		
Less Uncalled	100,000.00		
	400,000.00		
Less Unpaid Calls	10,000.00	$390,000.00	
Common	250,000.00		
Less Uncalled	25,000.00		
	225,000.00		
Less Unpaid Calls	5,000.00	220,000.00	610,000.00
Advance Payments on Calls			
Preferred 400 at $20.00			8,000.00
Common 200 at $10.00			2,000.00
			$720,000.00

The preference shares are preferred as to principal, at par or for amount paid up, in winding up. There is no further restrictive provision.

Costs of liquidation are $4,000.00. Calls in arrears are collected. There is interest of $200.00 accrued on advance payments on calls—$150.00 on preferred and $50.00 on common.

Make entries to close the accounts.

Solution.

Entries—

Cash	$10,000.00	
To Subscribers—Preferred		$10,000.00
Cash	5,000.00	
To Subscribers—Common		5,000.00

Liquidation Expenses	$4,000.00	
To Cash		$4,000.00
Creditors	100,000.00	
To Cash		100,000.00
Interest	200.00	
To Advance Payments—Preferred		150.00
,, Advance Payments—Common		50.00
Deficit	4,200.00	
To Liquidation Expenses		4,000.00
,, Interest		200.00
The Deficit is now $24,200.00.		
Advance Payments on Calls—Preferred	8,150.00	
To Cash		8,150.00
Advance Payments on Calls—Common	2,050.00	
To Cash		2,050.00
Capital Stock—Preferred	400,000.00	
To Shareholders—Preferred		400,000.00
Capital Stock—Common	225,000.00	
To Shareholders—Common		225,000.00
Shareholders—Common	24,200.00	
To Deficit		24,200.00
To transfer Deficit to Account for holders of Common Shares. As there is sufficient to pay the Preferred in full, the Deficit falls on the Common.		
Shareholders—Preferred	400,000.00	
To Cash		400,000.00
Payment of Preferred in full.		
Shareholders—Common	200,800.00	
To Cash		200,800.00
Payment of Balance of Cash to holders of Common Shares.		

The amounts received in advance of calls have been repaid before the repayment of paid-up capital.

Suppose now that A, a subscriber for ten shares of common stock, was $250.00 in arrears and the liquidator was unable to collect this amount. The default should not affect the amount to be received by the other shareholders.

With all calls paid there is $\frac{200800}{2500}$ or $80.32 payable on each share of common. A would be entitled to $\$80.32 \times 10 = \$803.20$. If his calls are not paid, the amount available is only $200,550.00, but to this add the arrears of $250.00 and divide on that basis, i.e. $80.32 for each share. Having found A entitled (had he paid his calls) to $803.20, deduct from

that the $250.00 arrears and pay him the balance of $553.20. In this way, by taking the arrears into account, each shareholder receives his correct amount on the assumption that all calls were paid, while the unpaid amount falls entirely on those in default. The actual amount of cash paid out to holders of common shares would be $200,550.00.

There were sufficient assets in A Company, Ltd., to adjust the situation in any way desired.

CHAPTER NINETEEN

CORPORATION TERMINOLOGY

Reading of financial statements and prospectuses may reveal many terms that indicate the issue of securities under many different titles. The titles, while possibly referring to securities under one or more general classifications, draw attention to special features that are attached to each and which differentiate between two or more kinds under a common class heading.

A knowledge of these terms is a necessary prerequisite to a complete understanding of financial statements or prospectuses where they appear. With this in view a reference to a number of such terms is given.

Participating Preferred Stock. This term draws attention to a privilege over and above an ordinary preference as to dividends. Preferred shares are non-participating unless stated to be participating. If participating, they carry a right to share further in the distribution of profits after a certain rate has been appropriated to junior shares. If said to be participating without further qualification the preferred shares are simple participating. This means that in the distribution of profits as dividends the first allocation will be to the preferred up to the rate fixed as a preference, with the next allocation to common up to the same rate as given the preferred. After this, if a further amount is appropriated, it will be applied to both preferred and common, as though they were of one class.

Problem. A company with $400,000.00 of 6 per cent. simple participating preferred stock and $200,000.00 common, appropriated $48,000.00 for dividends. What rates were declared?

Solution. The first step is the allocation of 6 per cent. or $24,000.00 to the preferred. The next step is the allocation of 6 per cent. or $12,000.00 to the common. There remains $12,000.00, which is appropriated as 2 per cent. on $600,000.00. Dividend rates are 8 per cent. on preferred and 8 per cent. on common.

In the above case the preferred commenced to participate further after the common had been given the rate fixed for the preferred as a preference and, unless otherwise indicated, this is the rule to be applied when the preferred is participating. The provision may, however, give a different basis.

Participating Immediately. Should the provision governing the preferred shares state that the preferred shall participate immediately, the first allocation is for the rate attached to the preferred, and any further distribution is made between the two classes of shares alike. If, in the problem just taken as an example, the preferred had been immediately participating, the

appropriation would have been first 6 per cent. to the preferred and then $24,000.00 on $600,000.00 preferred and common, or 4 per cent. The final rates would have been 10 per cent. to preferred and 4 per cent. to common.

PARTICIPATING SPECIALLY. Other and usually more involved provisions may be applied to the further participation by preferred shares, which are neither simple participating nor immediately participating. In such cases the preferred is said to be participating specially, and any such variation comes under the head of "special participation." One example of special participation would be a provision that, after the preferred is given the rate attached to it and common is given the same rate, any balance appropriated will be given to the preferred alone. Had this been followed in the preceding example, the allocation would have been: 6 per cent. to preferred, 6 per cent. to common and the balance of $12,000.00 as 3 per cent. to preferred. This gives the final rates as 9 per cent. to preferred and 6 per cent. to common.

Again, the provision may have been that after preferred received the rate attached to it and common a similar rate, the preference should participate in any balance distributed in the proportion of 2 to 1.

Problem. A company with $400,000.00 of 6 per cent. participating preferred and $200,000.00 common stock appropriated $46,000.00 for dividends. If it is provided that after the preferred shares have been allocated the rate attached to them, and the common have been given a similar rate, the preferred shall participate in any further distribution in any year in the proportion of 2 to 1, what rates of dividends were declared?

Solution. The first step is the allocation of 6 per cent. or $24,000.00 to the preferred, after which 6 per cent. or $12,000.00 is given to the common. There remains $10,000.00 of the appropriation. This is just sufficient to give 2 per cent. to the preferred and 1 per cent. to the common. The final rates are 8 per cent. to preferred and 7 per cent. to the common.

Suppose again that $52,000.00 had been appropriated and that after preferred and common had received the same rate the preferred was to participate in any further distribution in proportion of 1 to 2. After preferred is given 6 per cent. and common 6 per cent. there remains $16,000.00. To give preferred 1 per cent. and common 2 per cent. requires $4,000.00 + $4,000.00 = $8,000.00, so that $16,000.00 will provide for 2 per cent. on preferred and 4 per cent. on common. The final rates are preferred 8 per cent. and common 10 per cent.

Special participation may be in any manner provided and the greatest care is necessary in making the provision to avoid the necessity of litigation and a court interpretation. Provision as set out in the charter or by-law creating preferred shares determines the nature and extent of the preference.

Deferred Stock. Dividends on deferred stock are provided to be paid either at the expiration of a stated period or after the happening of a certain

event or the fulfilment of some condition. The term is not often met with in Canada but is more common in Great Britain. Deferred stock ranks after common stock, which divides common stock, when deferred shares are issued, into preferred common and deferred common. This division has been found in the case of railway companies where legislation authorized the division of common shares into these two classes. While such shares are issued to the public in some cases, they are frequently issued as founders' or promoters' shares.

Founders' Shares. Usually founders' shares are issued to the founder or promoter for services in organizing a company, or to the underwriters of the company's securities. Rights attached to founders' shares are as provided in the charter or by-law creating them, and so cannot be definitely defined in an abstract discussion, but where the "deferred" feature is provided it implies that while dividends on these shares are deferred until certain conditions have been reached, the rights may be very valuable from that point. The shares may have very little real value at the beginning but may become very valuable should the business become successful and a larger special allocation from profits is applied to these shares In Canada, founders' shares are not often met with, at least not under that title or with special rights.

Management Shares. Management shares are very often grouped with founders' or promoters' shares, as another name for the same class, and issued for services in management.

In some cases, when a new company is organized, and especially if the new company acquires the business of a number of formerly existing companies, continuity of policy and management is desired during the early years of operation. To ensure continuity of policy and management a few shares are issued to representatives of those interested in the formation of the company, and the holders of these shares have the right to elect the directors or remove them from office during a limited period. In at least one Canadian case three management shares were issued, one to a nominee of the bankers, one to the nominee of certain of those interested in the formation of the company, and the third to the nominee of these two. The right to control management holds (in this case) for a period of five years, after which such shares will automatically be converted into common shares. In the meantime, these shares are designated "Management Preferred" shares.

Prior Preference Stock. When, through the necessity for a reorganization of the capital structure, holders of preferred shares consent to a further issue of preference shares that rank before the original preference shares, prior preference stock is created. Such prior preference can be given only with the consent of those holders of shares who move down from first preference to second preference, and who make way for the prior preference. This class of shares is unusual, but there are companies that include the feature of prior preference shares. First and second preference shares may

be a feature without the idea of prior preference, which term is applied particularly where an existing first preference gives way to another issue, as has been here described.

Guaranteed Stock. The term "Guaranteed Stock" does not indicate any particular rights within the company that issues it, but means that the shares to which the term is applied are guaranteed as to dividends (or otherwise if provided for) by another company. A holding company will sometimes guarantee the dividends of a subsidiary company. The value of the guarantee depends on the strength of the guarantor company. Guaranteed stock should not be confused with preferred stock. A preference in itself does not carry any guarantee.

Voting and Non-Voting Stock. Unless the charter or by-laws of a company provide otherwise, all shares of capital stock have voting rights. Frequently, however, voting rights are confined to one class of shares until some stated condition arises. Usual practice is to give voting rights to common shares only, with a further provision that in the event of a certain number of preference dividends being passed and the preference dividends falling into arrears, voting rights shall be given to the holders of preference shares. Various provisions may be made to govern and, to know just what the voting rights of the different classes of shareholders are, a study of the charter and by-laws is necessary. In some cases the preference shareholders are given the right to elect a certain number of directors to represent them.

Transfer of Shares. As United States writers refer to share certificates as negotiable instruments, it is desirable that the accepted Canadian view be understood. Canadian legal authorities point out that stock or share certificates are not negotiable. This is supported also by a number of cases in Great Britain. In Smith *v.* Walkerville, it was held that shares are not negotiable, and although they may pass by delivery, they are subject to the equities. In this case a certificate for shares had been issued to one party who, for valuable consideration, transferred the certificate to another party The transferee delayed having the transfer registered in the books of the company. In the meantime the transferor transferred the shares for value to another (innocent) party who had himself registered without the production of the certificate. The court of appeal held that the plaintiff (first transferee) was cut out by the subsequent transfer and registration.

Other cases establish that a transferee who fails to have his transfer registered may lose his shares by a fraudulent transfer on the books of the company by a registered holder to a *bona fide* purchaser. In such case he has no action against the company for allowing such transfer. The holder under an unregistered transfer takes the shares subject to any defect in the title of the person from whom he acquires them, and if they had been stolen he has no title at all.

In Bonner *v.* Moray, a Quebec case, it was held that the delivery of a

share certificate endorsed in blank is not equivalent to a transfer or alienation of the certificate.

These cases draw attention to the risks of an unregistered holder. They draw attention to the underlying principle. An exhaustive study of the subject from legal texts will reveal many cases dealing with other features that have arisen in connection with transfer or pledging of shares. The different Companies Acts in Canada require registration of members and of transfers.

Transmission of Shares. A difference between transfer and transmission of shares is indicated by the manner in which the two terms are referred to in the Company Acts. A transfer is made through one person assigning his rights in the shares to another person. Transmission is the term used when rights in shares pass down to heirs or other beneficiaries under a will, or through the administration of the estate of an intestate deceased shareholder.

Inscribed Stock. Inscribed Stock is a term not associated so much with Limited Companies as with public corporations, such as governments. It means stock for which no actual certificates are given to the holders, but whose names and the amount of stock they hold are inscribed in a special register. Inscribed stock can be transferred only by the holder or his representative, acting under a power of attorney, signing the register that his rights have been assigned to another person. When considering inscribed stock issued by a government, the difference between it and debenture stock lies in the fact that in the case of debenture stock a certificate is given, stating the amount held by the owner, although the debenture stock also is registered and interest is paid by cheque, while in the case of inscribed stock no actual certificates are issued. Neither refers to shares.

Debenture Stock. This term does not relate to shares but is similar to debenture bonds, except that debenture stock is not issued in set denominations of amounts. The difference between debenture bonds and debenture stock is similar to the difference between shares and stock, i.e. transfers may be made in any amount, subject only as to provisions such as in even dollars or pounds, etc. Certificates are issued to the holder of debenture stock for the amount held. Interest is paid by cheque. Should a holder transfer a part of his holdings, a new certificate is given to the purchaser for the amount transferred and to the original holder for the amount retained.

Debenture Bonds and Mortgage Bonds. Both these forms of securities include a promise to pay certain sums of money at certain dates, and interest at a stated rate also at regular intervals. The difference between the Debenture Bond and the Mortgage Bond lies in the fact that in the former there is only the promise supported by the good name of the corporation, and its tax power or earning power, while Mortgage Bonds are supported by a pledge of definite assets as security.

Debenture bonds are issued by Governments and other public corporations, such as Municipalities, and by some public utility corporations, usually after an issue of Mortgage bonds.

Mortgage bonds are issued by public utility, industrial and trading corporations whose assets are pledged as security. The mortgage is held by a trustee and, being a deed held in trust, is called a trust deed.

While the distinction made is one generally recognized in Canada, the term "debenture" is sometimes applied to securities issued for money borrowed when there is a pledge of assets, thus using the term as it is very often applied in Great Britain.

There are many special terms used in connection with mortgage bonds, or bonds otherwise secured, each title being intended to indicate a special feature of the security. Some of these titles are important to the investor, who should know the real nature of the security behind his investment. They are of interest also to the accountant who would correctly interpret financial statements.

Closed Mortgage Bonds. When an issue is made of mortgage bonds described in this way, the term indicates that no further bonds are to be issued under the mortgage. The amount of the issue is definitely known, and the security behind the issue will not be impaired through later issues. Should further issues be made they will be junior to the prior issue.

Open Mortgage Bonds. The open mortgage is one under which successive issues of bonds may be made with no limit set as to the total. The issues may be made at long or short intervals and the holder of bonds of the first series may find his security lessened through later issues. Special provisions frequently are made to protect the investor against this procedure being carried too far.

Limited Open Mortgage Bonds. The limited open mortgage avoids some of the difficulties that may arise from either closed or open mortgages. Provision is made for a definite amount of bonds authorized to be issued, but the total need not be issued at one time. This method enables a corporation to issue bonds as funds are required, while the investor knows the total amount that may be issued under one mortgage.

It should be remembered that if funds obtained from later issues are used to acquire further assets that come under the mortgage, the security will be thus increased. However, the proportion of debt to security would be greater and the proportion of equity less.

After Acquired Clause. Should further assets as obtained come under the mortgage, it will be under an "after-acquired" clause, i.e. a clause that brings all property acquired after the mortgage is given, and during

the period of the mortgage, within the mortgage for security purposes. This may cause some difficulty unless precautions are provided for.

Purchase Money Mortgage. The difficulty that may arise from the "after acquired" clause is that it would make the mortgage a first claim on all property purchased and, unless provision is made, prevent the purchase of a property and the giving of a first mortgage to cover part of the purchase price. This is usually provided for by making an exception of "Purchase Money Mortgages" in an "after acquired" clause. It is then possible to give a mortgage for part of the purchase price, and the increasing equity created through payments made on the mortgage automatically comes under the mortgage securing the bonds.

Car or Equipment Bonds. These bonds are issued by railways for the purchase of rolling stock or other standard equipment. If the term used is "Car or Equipment Trust Bonds" it implies that the purchase of the equipment has been made under what is known as the lease method which is frequently employed when the railways have issued mortgage bonds that contain an "after acquired" clause. The plan followed in that case is for the railway to make arrangements for the building and purchase of the equipment and to make a first payment. Instead of the title to the property being given to the railway company, it is given to a trustee who leases the equipment to the railway for a moderate period, usually a few years, possibly up to ten, at such a lease charge that during the period of the lease will cover the balance due on the equipment with any other costs involved. Securities are issued in such a way that the payments on principal will be in accord with the terms of the lease. When the securities have been paid, the title is transferred to the railway company for a small consideration.

The proceeds from the issue of the bonds which are sold to the public are given to the trustee who completes the payment for the equipment. The trustee then holds the title to the equipment pending the completion of the transaction. In this way the effect of the "after acquired" clause is avoided during the period of the transaction.

Floating Charge. In addition to an issue of bonds being secured by a first mortgage on fixed and specified assets, provision is sometimes made for a floating charge on the other assets. A floating charge does not, from the beginning, act as a definite charge on the assets, but may be better described as hovering over and floating with the assets concerned, and which fixes itself and holds the assets in case of default under the mortgage. It thus becomes effective in case of default or of the corporation going into liquidation, etc. Until such time the floating charge, while applying to all items comprised in the security, does not specifically affect them. The floating charge, before it becomes crystallized and fixed, does not affect or interfere with the free use and disposal of the assets that may come under it. The floating charge usually applies to assets that are changed from time to time.

Funding Bonds. These are bonds issued to replace a floating debt, i.e. to convert a current debt into a bonded indebtedness.

Refunding Bonds. Bonds issued for the purpose of raising funds for the purpose of paying off a previous bond issue, or issued for the purpose of retiring a previous issue through conversion into the new issue, are refunding bonds.

Prior Lien Bonds. After an issue has been made of first mortgage bonds it may be found that more funds are required but that it may not be possible to issue, to advantage, second mortgage bonds. With the consent of the first mortgage bondholders (but not otherwise) an issue may be made that takes precedence over the first or former issue and which, having a prior lien, are prior lien bonds. Prior lien bonds are a feature in a reorganization of the financial structure, especially where there is an uncompleted structure which would occasion a loss if funds for completion are not obtained.

First and Refunding—General Mortgage Bonds. First and refunding bonds are not, at the time of issue, first mortgage bonds as applied to all the property. They constitute a first mortgage claim only on the equity remaining after previous issues. As previous issues are retired the equity is increased, and when all previous issues have been retired the first and refunding bonds become, in fact, first mortgage bonds. General mortgage bonds stand in much the same position. They are, at issue, secured by a general or blanket mortgage on all property of the corporation which is subject to mortgage previously given. Pending the retirement of the previous mortgages they, like first and refunding bonds, may be second or third, etc., mortgage bonds.

Collateral Trust Bonds. One corporation may own securities, either bonds or shares or both, of other corporations. These securities may be those issued by subsidiary corporations or by separate corporations. Such securities may be placed in the hands of a trustee as security for an issue of bonds. Bonds secured by the pledge of securities of other corporations are collateral trust bonds, i.e. they are bonds that are secured by collateral that is held in trust for the purpose. To understand the strength or weakness of the security it is necessary to study the position of such collateral.

A holding company holding the shares, preferred or common or both, of subsidiary companies may use such shares as collateral. The subsidiary companies may issue bonds of their own which are secured by a mortgage on the assets of the issuing corporation. The lien against such assets takes precedence over the company's shares. The security then behind the collateral trust bonds is the equity remaining after the mortgage bonds are satisfied. The income of the subsidiary companies also must provide for the interest on its own bonds and income for the shares pledged as collateral, for the collateral trust bonds of the holding company depend on profits being available for dividends. Should the holding company depend on

dividends for its income, their non-payment would be reflected in a lower value on the shares.

On the other hand, if securities so pledged as collateral constitute a first charge of the companies that have issued them, they may constitute a strong security. The strength of the collateral then depends on the equity and on the earning power behind it.

Income Bonds. The interest on income bonds does not constitute an irrevocable fixed charge, since they are issued with the condition that interest at the stated rate is payable only if earned after other fixed charges. The failure to pay the interest, if not earned, does not give the holders the right to take legal action.

Redeemable Bonds. Bonds issued with the condition that they may be called up by the issuing corporation for redemption before due, under stated terms, are redeemable bonds.

Convertible Bonds. Convertible bonds give the holder the right, under stated conditions, to convert his bonds into another form of security, usually shares.

Fully Registered Bonds—Registered as to Principal. Bonds issued as fully registered have no interest coupons attached. The name of the holder is written on the bond, a record is kept in the corporation's register, and payments of interest are made by cheque. These should not be confused with debenture stock. Registered bonds are issued and are transferable in definite denominations while debenture stock is not confined to fixed denominations.

Many issues of bonds are made with the privilege of being registered as to principal only. In such cases interest coupons are attached but the holder is protected against loss of the bond as to principal if he takes advantage of the registration privilege.

Gold Bonds. Gold bonds are usually issued payable in gold coin of a certain weight and fineness. This does not mean that the holder receives gold in payment of interest or principal, but he has the stated right to demand gold. This right is seldom exercised. In the event of a depreciation in currency there is a theoretical advantage in being able to demand gold, but whether gold could, under such conditions, be always obtained is another question, although its equivalent in currency should. Payments in currency are invariably accepted. In the case of external international loans issued payable on a definite gold basis, the holder of securities is protected against adverse fluctuations in the exchange rates.

Interim Certificates—Definitive Bonds. Interim certificates are frequently given when a sale of bonds to the public has been made. The holder is entitled to the bonds represented when they are available, but the

certificate serves to indicate his rights pending the completion of all matters relating to the issue and the preparation of the bonds themselves. When the bonds are available they are referred to as Definitive Bonds. The holder of the interim certificate hands it over to the trustee, usually through the financial house through which the purchase was made, and receives the definite security in the form of the definitive bond.

Rights. On making a new issue of shares, a limited company may offer them first to present shareholders in proportion to their respective holdings. Thus, if a company decides to increase its issued capital by 25 per cent. and offers the issue to present shareholders, each shareholder has the right to subscribe for one share for each four shares held by him. If the new issue is made at the then market value of the old shares, the rights have no particular value aside from tending to preserve the proportionate holdings of the shareholders and preventing the passing of a measure of control to outside parties. Usually, however, the new shares are offered at a lower figure than the market price at the time for old shares. Suppose the new shares are offered at 100 while the market price of the old shares is 125. The difference between the market price and issue price is $25.00 which, divided among 5 shares, gives the rights a theoretical value of $5.00, which is the loss in value per share. Another way of expressing this is—

4 shares at $125.00	=	$500.00
1 share at $100.00	=	100.00
Value of 5 shares	=	$600.00

$$\text{Value per share} = \frac{600.00}{5} \text{ or } \$120.00 \text{ a share.}$$

Value per share of right is $125.00 – $120.00 or $5.00.

Should a shareholder not desire to exercise his rights, he may sell them on the market and trading in rights is quite common. Fractional shares are not issued. A person holding ten shares should either purchase two rights or sell two in order that he may have an exact number required.

The value of the rights will fluctuate with the market value of the share. During periods of prosperity financing in this way is quite common but is not usual when the trend of market values is downward. Should a shareholder sell his rights, the effect to him is the same as that of a cash dividend. The value of the rights will be affected by the probability of the shares continuing the former rate of dividend and of the market value being maintained at present levels.

Special Reserves—General Reserve—Reserve Fund. A great deal of confusion may arise around the use of these terms, which makes it necessary to depend on the relationship rather than on the name when the terms appear in the accounts or in the balance sheet of a limited company.

Reserves for special purposes, such as to provide for bad debts or for depreciation, represent amounts retained out of revenue before the net profit

is determined, since the necessity arises directly from operations. If it is anticipated that a certain amount of accounts or bills receivable cannot be collected, an equivalent charge is made to profit and loss, which reduces net profit and retains out of revenue an amount equal to the anticipated loss. The amount so retained out of revenue is in the form of current assets which take the place, in the accounts, of the loss in current assets through bad debts and as represented by the Reserve for Bad Debts. It follows then that this is a special reserve against the receivables, that it is negative to them, and that the logical place in the balance sheet for the reserve is as a deduction from the receivables. To show it otherwise is to include the amount twice among the current assets—once in the receivables, which are not shown at a reduced amount, and again among the current assets specially retained out of revenue. In other words, unless this special reserve is deducted from the receivables, the current assets appear inflated and the working capital position is not accurately exhibited.

The discussion of the provision for bad debts applies to provision for depreciation, except that the fixed asset is reduced and the amount realized in the form of current assets. Reserves for depreciation should logically be deducted from the asset to which they relate for, if not, the result is that the amount retained out of revenue (not out of net profit) is included in the current assets and the amount is also included among fixed assets, which appear inflated.

There may be other reserves created by charges against revenue, each for a special purpose connected with operations. The funds (net assets) of the business are not recorded as increased by the creation of such reserves, since they signify the retention of amounts out of revenue to take the place of assets lost. It is true that the amounts are only estimated, but the estimate is believed to be reasonable and balance sheet values, which are accepted as true values as far as is possible, are based on these estimates. These reserves are not liabilities in the sense of amounts that are payable, nor are they confined to limited companies but apply to all forms of business organization.

A corporation, having earned profits, has next to decide whether the net profits shall be distributed or left available for distribution, except for compulsory appropriations, or retained or reserved within the business and so add to the funds to be employed in or by the business. The fact that a well-managed corporation will not usually distribute all its profits, but reserves or holds back a portion, has led to much confusion in terms.

As evidence of the intent to reserve profits from distribution it is usual to transfer the amount to be reserved from the Appropriation Account to the credit of an account representing reserved profits. If this account is called "Reserve" only, or "General Reserve," or, as in the case of some financial institutions, "Rest," the question of confusion is not so apt to arise. It indicates a reserve out of net profits for the general protection of the business, to add to the funds of the business and, in the event of operating losses, to protect the paid-up capital from impairment. Should it be later desired, a

portion or all of the reserve may be transferred back to the Appropriation Account, for appropriation as dividends, to cover a deficit, or for any other legal purpose. The amount, as long as it is retained within the business, constitutes a part of the shareholders' equity.

Difference of opinion arises when, instead of being designated as "Reserve," "General Reserve," or "Rest," the account for the credit is headed "Reserve Fund." It is not the purpose here to take the attitude that only one application of the term "Reserve Fund" is correct, but rather to present the opposing views, show that either may be quite logical, and then draw attention in particular to the situation in Canada as it relates to the term.

A special committee in the United States, under the auspices of the American Institute of Accountants, defines "Funded Reserve" as a reserve represented by actual funds set aside, usually in marketable securities, in part or wholly. That committee defines a "Reserve Fund" as cash or investments withdrawn from the working capital of an enterprise and specifically identified as representing the amount of a reserve (general or otherwise) set aside out of surplus. (This will be referred to as Definition No. 1.)

Some British authorities define a Reserve Fund as a reserve, either general or specific, represented by investments outside the business and cites Sinking Funds as one example of a Specific Reserve Fund. (This will be referred to as Definition No. 2.)

The substance of definitions by other British authorities is that a Reserve Fund is a voluntary appropriation of profits of an incorporated company, designed to retain within the business assets which might legally have been distributed in the form of dividends. (This will be referred to as Definition No. 3.)

Before referring to the general application of the term in Canada, attention is drawn to the difference in the ideas expressed in the definitions as given. At first glance the first and second definitions of Reserve Fund may appear to have the same meaning but they have not.

The definitions of Funded Reserve, as given above, and Definition No. 2 for Reserve Fund are in agreement, but in the three definitions of Reserve Fund three different ideas are expressed.

In Definition No. 1 the reference is to an investment fund which, while representing the amount of a reserve, is not the reserve.

In Definition No. 2 the term "Reserve Fund" is applied to a reserve and not to an investment, but there is no inference that the Reserve Fund needs to be represented by an investment. It cannot be represented otherwise than by assets but the assets need not be segregated.

All three ideas brought out are logical enough. That a fund should be in the form of investments or bank deposits is consistent. The "Reserve" shows the amount reserved and the Reserve Fund indicates the form in which it exists.

Definitions Nos. 2 and 3 bring out an accounting aspect that is of interest. To say that a Reserve Fund Account must be an asset account may tend to lose sight of that accounting aspect. No doubt the feeling on the part of some accountants that the word "fund" should refer to definite and segregated assets in realizable form has drawn attention away from the intended significance of a Reserve Fund Account with a credit balance.

The accounts for capital have credit balances, but capital exists in the form of assets, and it is not unusual for a student commencing the study of accounts to ask why capital is not shown as an asset. The purpose of the capital accounts is to record the amount contributed as capital and so, in a limited company, the amount of shareholders' equity represented by capital funds contributed. That which has been contributed was recorded in the assets under suitable titles when Capital Account was credited. The actual capital then is in the form of assets (less liabilities, etc.) while the Capital Account shows directly the amount of contributed capital.

Under definitions Nos. 2 and 3 the Reserve Fund Account stands in a relation somewhat similar to Capital Account. The account records the amount of profits so reserved, which amount represents a part of the shareholders' equity. Instead of the amount being *paid* in as in the case of capital funds, it has been *left* in from profits when it might have been taken out. All profits are represented by assets and the assets are recorded in their various accounts. The amount reserved is thus among the assets, but whether segregated as investments or used in business operation and so a part of the whole mass of assets does not affect the fact of the fund's existence. The only difference between the ideas expressed in Definitions No. 2 and No. 3 is that No. 2 assumes that the amount reserved is represented by a definite investment, whereas in No. 3 the idea is that there may or may not be a definite investment, and the fund exists whether there is a specific investment or not.

The last view is widely held in British practice and is quite generally found in Canadian practice. In Canadian statutes relating to Banks, Trust Companies, etc., the term "Reserve Fund" is used to represent net profits reserved or held back from distribution, and the amount recorded at the credit of the account without any reference to a segregation of assets as an investment to an amount corresponding to the credit in Reserve Fund Account. It is made clear also that the terms "Reserve Fund" and "Rest" are synonymous, and the terms "Reserve," when used alone and without qualification, and "General Reserve" are in practice applied with the same meaning.

This view is supported by legal decisions in Canada. When the Courts

were asked to decide on the contention that because the company, while it had a credit in Reserve Fund Account, had no definite corresponding investment, it actually did not have a Reserve Fund, the following decision was given—

"Such a fund is a very common feature in well-managed and prosperous companies of all kinds, and it consists of moneys made or saved as a result of their operations from year to year and not paid out in dividends to their shareholders. Instead of being left as a floating balance at the credit of profit and loss account, it is transferred to another account and called the rest account or reserve account or surplus; but, under whatever name it may exist, it is simply the company's current surplus of assets over liabilities, treating the paid-up capital as a liability. Per Street, J., in Toronto *v.* Consumers' Gas Co. (1903), 5 O.L.R. 494, at pp. 499-500."

In another case the Court held that—

"A reserve fund may consist of goods as well as money: Gignac *v.* Gignac & Cie (1910), Que. 37 S.C. 174, per Lemieux, J., at p. 184."

The above does not mean that a company may not set up an investment at an amount that corresponds to the amount of the Reserve or Reserve Fund, but it does appear quite clear that the investment is not a necessary feature to the Reserve Fund. A company may or may not arrange for a corresponding investment as it wishes. This is referred to in the legal decision that follows—

"The directors of a company, in the absence of provisions to the contrary in the letters patent or by-laws, and subject to the control of the shareholders, are entitled to maintain a rest or reserve fund and are not bound to distribute the whole of the profits among the shareholders. The reserve fund may lawfully be invested in such securities as the directors may select, subject to the control of a general meeting of the shareholders, and it is not *ultra vires* for a company to invest its profits in the name of a sole trustee, who will be strictly accountable for all investments held by him. If the directors prefer to do so, subject to the control of the shareholders, they may retain the profits as an undivided fund standing at the credit of profit and loss, or appropriate them to any other use of the company: Burland *v.* Earle (1902), A.C. 83; City of Toronto *v.* Consumers' Gas Co. (1903), 5 O.L.R. 494; Kennedy *v.* Acadia Pulp, etc., Co. (1905), 38 N.S.R. 291."

A Sinking Fund Reserve is a specific Reserve Fund against which is a corresponding Sinking Fund Investment. After the investment has been applied to the retirement of a debt, the Reserve is found not to have been affected. As its purpose has been served, it may be transferred to the credit of Reserve Fund Account and it is still represented by assets, but the assets are not segregated. They are within the business as a part of all assets. There is thus no direct necessary connection between a Reserve Fund and a specific investment of funds.

If the purpose of a Sinking Fund is to replace an asset, the Reserve is in effect a Depreciation Fund and not part of the General Reserve Fund. It is finally disposed of by applying it to close out the asset account against which it had been accumulated.

It is usually found in Canadian practice that the term "Reserve Fund" carries the same meaning as the terms "Reserve" (not qualified), "General Reserve," or "Rest," and that the credit in accounts under any of these titles does not necessarily imply any corresponding segregated investment. Should the Reserve be represented by a corresponding investment it is because of a specific purpose, and the title used indicates something of that purpose. At the same time, there is no definite and fixed connection between the investment and the Reserve and either may be closed out without affecting the other.

In the course of time possibly uniformity will be attained in the meaning applied to the term "Reserve Fund."

CHAPTER TWENTY

SOURCE AND APPLICATION OF FUNDS

General Principles. A comparison of financial statements covering different periods reveals changes that from time to time have found their way into the business relationships. It may be that the working capital position has improved over that of a previous period, or the reverse may be in evidence.

The value of properly constructed balance sheets cannot be over-stressed for, unless a balance sheet is so drawn that it reveals all that is possible relative to the financial position of a business, it fails to meet its purpose.

Having accomplished that much, a comparison of balance sheets under different dates raises the question of the cause of the changes that are in evidence. There are in reality two questions. One is as to what changes in general have taken place and the other is as to the cause of change in the working capital position.

Current assets are constantly changing as are also current liabilities, due to the conversion of one current asset into a current asset of another form, application of current assets to the discharge of liabilities, application of current assets to acquiring fixed assets and increase of current assets from various sources.

Profits are represented by an increase in assets and in trading operations this increase is almost always in current assets. Profits thus provide a source of additional funds or working capital.

In providing for depreciation, assets acquired from sales are retained within the business to take the place of the amount of reduction in fixed assets and the amount provided for depreciation is thus represented by an increase in working capital and is a source of funds. The same idea applies to the amount of bond discount amortized.

Further issues of shares or of bonds act as a source of funds, as do also bank or other loans, although the working capital position in dollars is not changed in the case of bank loans. The relation between current assets and current liabilities expressed as a percentage or proportion is changed. The same idea is brought in by an increase of accounts or bills payable since, instead of meeting liabilities, the funds available are used for other purposes.

A review of the general features affecting changes in assets, liabilities, capital and surplus makes evident that decreases in assets, increase in

liabilities and increase of capital and earned surplus provide sources from which funds are obtained. Should cash at the end of a period be less than at the beginning, the meaning is that the difference representing the excess of payments over receipts has been drawn on and used.

Applications of funds are shown in the reduction of liabilities, increase in assets, payment of dividends, etc. Funds may have been tied up in increased accounts and bills receivable or inventories. Funds may have been applied to the acquiring of fixed assets which, since it involves a reduction in current assets and an increase in fixed assets, has a direct bearing on changes in the working capital position.

Discussion has dealt with the general principles involved. An example better illustrates the application of those principles.

Problem. From the information submitted prepare—

(*a*) A statement showing the sources and application of funds during the year.

(*b*) A statement accounting for the change in the working capital position.

Assets

	December 31 1935	December 31 1936
Cash	$15,000.00	$16,000.00
Accounts Receivable	120,000.00	95,000.00
Bills Receivable	40,000.00	35,000.00
Inventories	35,000.00	20,000.00
Land	10,000.00	20,000.00
Buildings	80,000.00	150,000.00
Plant and Machinery	90,000.00	115,000.00
Equipment	5,000.00	8,000.00
Discount on Bonds	9,000.00	8,000.00
Deferred Charges	800.00	1,400.00
	$404,800.00	$468,400.00

Liabilities, Reserves, Capital, etc.

	December 31 1935	December 31 1936
Accounts Payable	$30,000.00	$28,000.00
Bills Payable	40,000.00	31,000.00
Bank Loan	12,000.00	18,000.00
Mortgage Bonds	150,000.00	130,000.00
Reserves for Depreciation—		
Buildings	12,000.00	16,000.00
Plant and Machinery	20,000.00	30,000.00
Equipment	2,000.00	2,600.00
Capital Stock	120,000.00	180,000.00
Surplus	18,800.00	32,800.00
	$404,800.00	$468,400.00

The surplus is accounted for as follows—

Balance, December 31, 1935	$18,800.00
Net Profits, 1936	30,000.00
	48,800.00
Less Dividends	16,000.00
	$32,800.00

Solution. (*a*)

Sources of Funds made available for increase in Assets or reduction of Liabilities

Accounts Receivable	$25,000.00
Bills Receivable	5,000.00
Inventories	15,000.00
Discount on Bonds	1,000.00
Bank Loans	6,000.00
Provision for Depreciation—	
Buildings	4,000.00
Plant and Machinery	10,000.00
Equipment	600.00
Capital Stock	60,000.00
Net Profits	30,000.00
Total	$156,600.00

Application of funds—

(i) Increase in assets—		
Cash	$1,000.00	
Land	10,000.00	
Buildings	70,000.00	
Plant and Machinery	25,000.00	
Equipment	3,000.00	
Deferred Charges	600.00	$109,600.00
(ii) Reduction in liabilities, etc.—		
Accounts Payable	$2,000.00	
Bills Payable	9,000.00	
Mortgage Bonds	20,000.00	
Dividends Paid	16,000.00	47,000.00
Total		$156,600.00

(*b*)

Working Capital Position
December 31, 1935

Current Assets—	
Cash	$15,000.00
Accounts Receivable	120,000.00
Bills Receivable	40,000.00
Inventories	35,000.00
Total Current Assets	$210,000.00

Continued on next page

Current Liabilities—	
Accounts Payable	$30,000.00
Bills Payable	40,000.00
Bank Loans	12,000.00
Total Current Liabilities	$82,000.00
Working Capital	128,000.00
	$210,000.00

Working Capital Position
December 31, 1936

Current Assets—	
Cash	$16,000.00
Accounts Receivable	95,000.00
Bills Receivable	35,000.00
Inventories	20,000.00
Total Current Assets	$166,000.00
Current Liabilities—	
Accounts Payable	$28,000.00
Bills Payable	31,000.00
Bank Loans	18,000.00
Total Current Liabilities	$77,000.00
Working Capital	89,000.00
	$166,000.00
Working Capital, December 31, 1935	$128,000.00
Working Capital, December 31, 1936	89,000.00
Decrease in Working Capital	$39,000.00

Accounted for as follows—

(i) Working Capital added to by—		
Discount on Bonds	$1,000.00	
Depreciation—Buildings	4,000.00	
,, —Plant and Machinery	10,000.00	
,, —Equipment	600.00	
Capital Stock	60,000.00	
Net Profits	30,000.00	$105,600.00
(ii) Working Capital reduced by—		
Land Purchased	$10,000.00	
Buildings	70,000.00	
Plant and Machinery	25,000.00	
Equipment	3,000.00	
Deferred Charges	600.00	
Mortgage Bonds Paid	20,000.00	
Dividends Paid	16,000.00	$144,600.00

Excess of funds applied outside
of current purposes over
Additions to current funds $144,600.00 – $105,600.00 or $39,000.00

The reduction in working capital is accounted for in this way.

POINTS DEDUCED FROM FOREGOING. A study of the statements that have been submitted reveals that it is quite possible to earn large profits and yet show an impaired working capital position. The cause of the impairment may be readily accounted for by means of the statements.

In a similar manner, it can be shown how the cash position may be made less favourable although cash has been added to from various sources.

The first statement gives a picture of the changes among the assets as a whole and of the shuffling that is constantly taking place. The second statement deals solely with changes in working capital—additions thereto and deductions therefrom.

Even with an increased working capital current financing may be more difficult. The statement of working capital changes may reveal that cash has been depleted and that funds are tied up in increased inventories and receivables and so, pending realization of these, are not available for immediate use.

Other Points to Consider. A Stock Dividend would have no effect on working capital. There is no transfer of assets. The only transfer is from Surplus to Capital Stock. Should there be both Cash and Stock Dividends, only the Cash Dividends would be considered as affecting the working capital position.

In the case of a Sinking Fund, the investment is not a current asset. The payment to the investment comes out of current assets and so does affect the working capital position.

An appropriation to Sinking Fund Reserve has no effect except in determining the amount of free surplus.

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